

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2010

TUESDAY, JUNE 9, 2009

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 10:30 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Lautenberg, Nelson, Tester, Collins, and Bond.

DEPARTMENT OF THE TREASURY

OFFICE OF THE SECRETARY

STATEMENT OF HON. TIMOTHY F. GEITHNER, SECRETARY

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good morning. My apologies. I was on the floor, defending the administration, that's all I can say. To my colleagues, I apologize.

Please convene this hearing to examine the fiscal year 2010 funding request of the Department of the Treasury, including the Internal Revenue Service (IRS). Mr. Secretary, thank you for joining Senator Collins and my other colleagues this morning. We know that IRS Commissioner, Doug Shulman, is also here and prepared to testify.

And I am going to waive the remainder of my opening statement, in the interest of time, and to allow my colleagues to say few words so that we can catch up with the schedule.

Senator Collins.

STATEMENT OF SENATOR SUSAN COLLINS

Senator COLLINS. Thank you, Mr. Chairman. Secretary Geithner, Commissioner Shulman, I am very pleased to welcome you to this hearing and I thank you for your service to our Nation.

Mr. Secretary, you have so many challenging responsibilities that it's difficult to know where to begin. You're responsible for reinvigorating bank lending to consumers and small businesses, stabilizing the housing markets, overseeing the automobile industry and encouraging sustainable economic growth. Most important, you must try to protect American taxpayers and their investments and pro-

mote the long-term financial security of the United States at a time of unprecedented debt.

The current financial crisis is rooted in a tangled web of high-risk financial instruments backed by high-risk loans, issued by high-risk individuals. To emerge from this crisis and to overcome its effects, we must restore trust in our Nation's financial institutions and financial markets. And, in my view, that will require significant reforms in our system of financial regulation, an issue that I want to discuss with you today.

Several developments are shaking American's trust in the economy. First among these is the dangerous increase in our Nation's long-term debt. While I supported the short-term fiscal stimulus as necessary to get our economy back on track, I am troubled that the President's budget proposes to double the debt in 5 years and triple it in 10. I am concerned that the long-term debt proposed by this administration poses a threat to the sustainability of our economy. Where will the money come from to pay these debts? China, where you have recently visited? Saudi Arabia? Sovereign wealth funds? Will this public debt crowd out private investment and slow the recovery? Who ultimately will pay for this—our children and our grandchildren? We need to assess what we're doing to our country's long-term financial health.

Finally, Mr. Secretary, I remain very concerned, as I indicated to you in our conversation yesterday, about the management accountability and transparency of the troubled asset relief program (TARP) fund. Originally, TARP was envisioned as a fund to prevent our largest banks and financial institutions from failing and to increase liquidity in our credit markets. Today, however, TARP encompasses 12 different programs, not just for banks but also for insurance companies and automobile manufacturers, and involves Government funds combined with private funds adding up to almost \$3 trillion.

It is disturbing to me that we really cannot assess what impact TARP funds has had on recipients, and whether TARP has truly increased lending. And the Treasury Department has yet to articulate how it will measure whether this injection of capital has been an effective use of taxpayer dollars. I am concerned that we're being asked simply to trust that this large infusion of capital into the economy will lift us out of a severe financial crisis, whose complex origins are still being untangled.

Secretary Geithner and Commissioner Shulman, you both face great challenges in managing the Federal Government's finances and attempting to reinvigorate our economy. These truly are extraordinary times. I pledge to work very closely with you, as well as with our chairman, to make sure that you have the staff, the authority, and the resources that you need to serve the American people.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Collins. I am going to invite my colleagues to make brief opening statements.

And Senator Lautenberg, I recognize you.

STATEMENT OF SENATOR FRANK R. LAUTENBERG

Senator LAUTENBERG. Thanks very much Mr. Chairman. Greetings Mr. Geithner, Secretary Geithner. You've taken on a formidable task and, so far, I think that the score in the ball game is going your way, but we are quite a distance from the ninth inning.

As we meet today, the economy is slowly beginning to show signs of a possible recovery and the challenges still remain. This recovery will require strong reforms to place our financial system on a firm footing. We've got to give the regulators the tools that they need to predict and prevent financial crisis.

And we've got to change corporate culture. That says, the people, the leadership at the top, can often take its compensation without regard for what happens with the employees or the future investing for the well-being of the company and taxpayers.

I am still on the board of the Columbia Business School and some time ago I gave them the chair, I was out of the Senate for a couple years, I took a hiatus, and what I proposed was that salaries at the top be related to salaries at the bottom. And instead of letting the ratio slip as it has, from 40 times typically in the eighties, to 400 times recently at times, and also—and I don't know, Mr. Secretary, what kind of latitude you have or what kind of authority you have to suggest conduct in the CEOs office. But one of the things I think we have to look at while we change this corporate culture is to make it clear that, when an executive retires, that the reward ought to be, my view, in the performance of the company after the leader leaves. And the bonuses should be expanded as time goes by, and not simply related to the stock price. Because stock price may be at the expense of investing in the future of the business.

Anyway, we're glad to see you here and urge you to carry on and work hard. Thank you.

Senator DURBIN. Senator Nelson.

STATEMENT OF SENATOR BEN NELSON

Senator NELSON. Thank you, Mr. Chairman. Secretary, we are glad you're here. We appreciate the efforts that you are providing and that the progress that we hope will come will, in fact, come.

When I go home, I have people come to me complaining about the bailouts, complaining about TARP, complaining about putting the auto industry into bankruptcy and they're all concerned about that. They're concerned also about the growing deficit and the increasing budget. The one thing that they are now becoming alarmed about is the Government ownership of stock. And when we come to the questions, I've got some questions about that. Because they come to me and say, look, aren't we drifting into socialism at a rapid rate. And I assure them that our goal is not to hold the stockholdings or warrants or any other financial instruments that we shouldn't be holding. That our goal is to get these companies so that they are functioning on their own, so that they are either publicly traded or that they are privately owned, but not Government owned. So, I'll be asking you for reassurance on that side.

Because I hope and I believe that our goal is just as I've stated it, to help these companies get on their feet and, when on their

feet, to become private once again, not to have that kind of public ownership that we currently have. So I'll be anxious to get your take on that.

Thank you, Mr. Chairman.

Senator DURBIN. Senator Tester.

STATEMENT OF SENATOR JON TESTER

Senator TESTER. Thank you, Mr. Chairman. Commissioner Shulman, Secretary Geithner. It's good to have Secretary Geithner and Commissioner Shulman here today. I've gotten to visit with Secretary Geithner on several occasions and I look forward to the one today.

We have just, we have just experienced, over the last little over 1 year, the biggest economic downturn since the 1930's. We have seen irresponsibility on Wall Street, we have seen irresponsibility in Government, with a lack of regulation. In some cases, no regulation. We have stepped forth with the TARP program, we have stepped forth with the recovery bill. You are in the eye of the storm.

I look forward to visiting with you about all those things that impact the economy and where we're going from here. And I appreciate your coming in front of the subcommittee.

Thank you.

Senator DURBIN. Senator Bond.

STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you very much, Mr. Chairman, Ranking Member Collins. Welcome, Secretary Geithner.

Everybody knows, over the past year, we've had a major economic storm raging with great damage to everybody. The Federal Government has responded to the economic crisis with aggressive and unprecedented, but unfortunately, I believe, ad hoc actions through taxpayer-funded bailouts of too-big-to-fail private corporations, a \$1 trillion stimulus, foreclosure rescue programs, just to name a few.

We've seen some positive signs of green shoots, but there are some wondering whether they will wither away due to continuing problems in the housing sector, consumer debt remaining high, significant de-leveraging occurring in the financial sector, and lingering questions about the solvency of banks. Are we seeing a "dead cat bounce" in the markets?

Economic and financial experts are telling us that economic recovery cannot occur or be sustained until we address the root cause, the credit crisis. That's what TARP was supposed to do, but it got off on the wrong foot last fall, in my view, and it's still there. And President Obama told us in January we can't have a recovery until we get the toxic assets out.

These are questions that I want to follow-up with. The size of the stimulus also is now causing questions from the Federal Reserve. If we get in a position of monetizing our debt, we will face an unprecedented disaster and go the way perhaps of Argentina. And tripling the debt in 10 years seems to me to be a very risky approach.

We've seen the United Kingdom, which was recently warned about its credit rating. Perhaps that is the canary in the coal mine for our Nation's own future.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you very much, Senator Bond.

[The statement follows:]

PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

Thank you Chairman Durbin and Ranking Member Collins for holding today's hearing on the Department of the Treasury and the Internal Revenue Service (IRS). I welcome both Treasury Secretary Timothy Geithner and IRS Commissioner Douglas Shulman and thank them for appearing before our subcommittee.

Over the past year, a major economic storm has raged across America causing hardships and damage to families, communities, and businesses. Families have lost their jobs and homes. Retirement savings have plummeted turning 401(k)s into "201(k)s." Students have seen their college savings evaporate. And, our financial and auto industries have been shaken to their core.

The Federal Government has responded to the economic crisis with aggressive and unprecedented, albeit ad hoc, actions through taxpayer-funded bailouts of "too big to fail" private corporations, a trillion dollar stimulus, and foreclosure rescue programs, just to name a few.

In recent weeks, some have identified positive signs of economic recovery or "green shoots." But other experts believe that these green shoots may just wither away due to continuing problems in the housing sector, consumer debt remaining high, significant deleveraging occurring in the financial sector, and lingering questions about the solvency of some of our big banks. As they say in the financial industry, we may be experiencing a "dead cat bounce."

Economic and financial experts believe that true economic recovery cannot occur or be sustained until the root cause of the crisis is addressed—the credit crisis. The financial system cannot be fully repaired unless the toxic assets are cleansed from the balance sheets of financial institutions. I strongly agree.

Unfortunately, the administration has failed to develop or execute a credible plan to cleanse the toxic assets that continue to choke our financial institutions. The centerpiece of the administration's financial rescue plan to remove the toxic assets—the Public-Private Investment Program or "PPIP"—remains sidelined, and based on the recent comments by leaders such as Secretary Geithner's successor at the Federal Reserve Bank of New York, the growing sentiment is that it will never be launched.

Due to fundamental flaws with the design of PPIP that placed most of the risk at the taxpayers' feet, it is frankly no surprise that this program has stalled and is not likely ever to be implemented.

It cannot be emphasized enough that a well-functioning credit market must be restored for economic recovery. Too much money has been thrown at our financial institutions without removing the toxic assets, and further delay only makes the problem worse as we have seen with Japan in the 1990s. The good news is that we can face this 800-pound gorilla by using a true-and-true approach that helped our Nation recover from the Savings and Loan Crisis.

Unfortunately, the administration has resisted the creation of a Resolution Trust Corporation approach but continues an ad hoc, incremental approach to our "too big to fail" financial institutions without any semblance of an exit strategy.

But when it comes to our domestic auto industry, the administration has not shied away from taking a different approach. It fired the head of General Motors and orchestrated the bankruptcy of both GM and Chrysler.

The creation of jobs will be an essential ingredient to economic recovery and President Obama has staked his performance on this measure. The administration's main effort to create jobs was a trillion dollar "stimulus" bill with the promise of saving or creating at least 3 million jobs, which would prevent the unemployment rate from rising above 7.8 percent. Clearly, this estimate was overly rosy as the most recent jobs report showed that unemployment had reached 9.4 percent.

To be fair, the sliding economy necessitated a significant fiscal stimulus. But instead of stimulating the creation of jobs, so far, it only seems to be stimulating the growth of Government programs and ballooning our debt.

While the lack of stimulus is extremely troubling, what is truly alarming is the administration's future budget plan, which promises more spending that will double the debt in 5 years and triple the debt in 10 years. This means that our children are going to inherit an obligation where interest payments on the debt—around

\$800 billion annually—are likely to be the largest single item of the Federal Government. These figures are certainly not funny to future generations, but it is difficult not to laugh when administration officials publicly claim that lending money to the U.S. Government is still safe.

Frankly, our country's fiscal health and viability are serious matters that must be addressed sooner than later. There are recent signs of investor concern about our Nation's fiscal health. Interest rates on 10-year Treasury notes have recently shot up. This means that the Government's cost to borrow money will increase by tens of billions of dollars. One of the most stable and industrialized nations in the world, the United Kingdom, was recently warned about its credit rating. What is happening in the United Kingdom should be viewed as a "canary in the coal mine" for our own Nation's future fiscal situation. Even Federal Reserve Chairman Ben Bernanke recently called for our Nation to begin planning now for the restoration of fiscal balance.

The good news is that we still have the opportunity to change course, but we can only do so if there is the will to confront the most treacherous political landmines, such as entitlement spending. Much has been said publicly about the importance of our fiscal health and the commitment to tackle spending matters. However, action speaks louder than words, and until I see action, many Americans, including myself, will continue to sound the alarm.

Thank you.

Senator DURBIN. Mr. Secretary, the floor is yours.

SUMMARY STATEMENT OF HON. TIMOTHY F. GEITHNER

Secretary GEITHNER. Chairman Durbin, Ranking Member Collins, and members of the subcommittee, it's a pleasure to be before you today, my first time appearing before you about the Treasury's budget. I look forward to building a close working relationship and I look forward to having a chance to answer the many important questions you raised in your opening statements.

While we see some initial signs of economic improvement, I think you could say that the force of the storm is weakening a bit. And although the financial system is beginning to heal, our country faces very substantial economic and financial challenges.

Now the President and the administration are working to meet these challenges. We are working hard to get Americans back to work, to get our economy back to a growth path again, by committing to restoring fiscal discipline to ensure and sustain recovery and by making the long-neglected investments in healthcare reform and energy and education necessary to improve the productive capacity of our economy and to ensure that, over the longer term, we enhance the competitiveness of the U.S. economy.

To achieve these goals, we are working to repair and reform our financial system so that it works for, not against, recovery. We are working to restore growth and meet our fiscal goals by redesigning our Tax Code, bolstering enforcement. We are working to advance our interests globally, working with other countries to promote economic recovery and financial repair and to ensure more open markets for U.S. businesses.

And to protect our Nation's national security interests, we are deploying all of the tools at our disposal to exclude terrorists, proliferators, and other illicit actors from the international financial stage and thereby secure our financial system and prevent threats to our security.

Now, the fiscal year 2010 budget you have before you will allow Treasury to pursue these core missions. The \$13.4 billion request includes a \$676 million, or 5.3 percent increase over the enacted 2009 levels.

Just a few brief highlights about the budget request. Of the increase we are seeking, \$14 million would go to bolstering the staffs of our domestic finance and tax policy offices. Now, these offices, domestic finance and tax policy, are at the center of the administration's efforts to support strong design, rigorous analysis, improve the financial system, reform the financial system, and implement reforms to our tax policies and Tax Code.

We include in the budget a \$137 million request to more than double our community development financial institutions, our community development financial institutions (CDFI) fund, to ensure that the benefits of our financial efforts reach beyond major banks and businesses to help economically distressed communities. These communities were underserved by our financial system even before the current crisis and they have been deeply hurt by the job losses and business failures that the crisis has exacerbated.

We propose a total of \$332 million for new IRS enforcement efforts, including \$128 million to add nearly 800 new IRS employees to combat offshore tax evasion and improve compliance with the U.S. international tax laws by businesses and high-income individuals. Another \$130 million would go to bolster the security of the IRS's information technology, improve the efficiency of its business systems, and upgrade its fraud detection capabilities.

Now, although not directly under the jurisdiction of the subcommittee, I just wanted to note also that our budget includes funds to meet our international obligations and to help us craft a global response to the crisis in this more integrative global system we live in today.

Now, as we seek these additional funds to respond to our Nation's immediate challenges, we've cut back on some programs that are either ineffective or we believe can be safely deleted. Just one example, even as we are trying to increase capital investment for the IRS, our budget would reduce the Department-wide Treasury's Department-wide capital investment account by 65 percent, for a modest savings of \$17 million.

Now, just before I end, I want to say a few words about the Treasury staff. I have the honor of leading a team of exceptionally smart and dedicated individuals who are working very hard to make our Government more effective. They're performing a great service to our country under challenging circumstances. I am very grateful to them and I think if you look at the scale of what we've set in motion, just in the last 6 months, they have done extraordinary things in a very short period of time.

PREPARED STATEMENT

Thank you, Mr. Chairman, I'd be happy to answer any questions.
[The statement follows:]

PREPARED STATEMENT OF TIMOTHY F. GEITHNER

Chairman Durbin, Ranking Member Collins, members of the Subcommittee, I appreciate the opportunity to testify before you for the first time as Treasury Secretary on the President's fiscal year 2010 budget request for the Department of the Treasury.

While we see some initial signs of economic improvement and the financial system is beginning to heal, our country faces very substantial economic and financial challenges.

President Obama and his administration are working to meet these challenges by getting Americans back to work and getting our economy to grow again; by restoring fiscal discipline to ensure a sustained recovery, and by making the long-neglected investments in health care, energy and education needed to enhance America's global competitiveness and produce more balanced, sustainable growth over the long-term.

TREASURY'S KEY PRIORITIES

To achieve these goals, we are repairing and reforming our financial system so that it works for, not against, a recovery that serves all Americans.

To restore growth and meet our fiscal goals, we are redesigning and bolstering enforcement of our tax code so that it is both fairer and more efficient.

To advance our interests globally, we are working with other nations to promote economic recovery and financial repair, and to ensure more open markets for U.S. business.

And to protect the country, we are deploying all of the tools at our disposal to exclude terrorists, proliferators, and other illicit actors from the international financial stage, and thereby secure our financial system and combat threats to our security.

The fiscal year 2010 budget that you have before you will allow Treasury to pursue these core missions assigned to the Department by the President and the Congress. The \$13.4 billion request includes a \$676 million, or 5.3 percent, increase over enacted 2009 levels.

Of this increase, \$14 million would go to bolstering the staffs of our Domestic Finance and Tax Policy offices, which are at the epicenter of administration efforts to support rigorous analysis and implementation of revenue policy and to redesign and improve our tax policies and tax code.

Some \$137 million would be devoted to more than doubling our Community Development Financial Institutions (CDFI) Fund to ensure that the benefits of our financial repairs reach beyond our major banks and businesses to help economically distressed communities. These communities were underserved by our financial system even before the current crisis, and have been deeply hurt by the job losses and business failures that the crisis has spawned.

A total of \$332 million would be devoted to new Internal Revenue Service (IRS) enforcement efforts, including \$128.1 million to add nearly 800 new IRS employees to combat offshore tax evasion and improve compliance with U.S. international tax laws by businesses and high-income individuals. Another \$130 million would go to bolster the security of the IRS information technology, improve the efficiency of its business systems and upgrade its fraud detection capabilities.

Although not directly under the jurisdiction of this Subcommittee, our budget also includes funds to meet our international obligations to help us in mounting a global response to the crisis and in creating mutually reinforcing growth around the world.

As we seek these additional funds to respond to our Nation's troubles, we have cut back on some programs that are either ineffective or that we believe can be safely delayed.

For example, while the Earned Income Tax Credit (EITC) continues to be one of the most effective anti-poverty programs that the Federal Government administers, the Advanced EITC, a related program which provides benefits in advance of filing a tax return, has been prone to exceptionally high levels of error and low use by those eligible for it. Accordingly, our budget proposes to end this latter program for savings next fiscal year of \$125 million.

Similarly, even as we seek to increase capital investment for the IRS, our budget would reduce the Department-wide capital investment account by 65 percent for a savings of \$17 million.

The Treasury budget would reduce the number of international economic attachés from 20 to 16, saving \$2 million next fiscal year. It would absorb a portion of our non-pay inflation through more efficient use of contracting and other cutbacks, saving \$18 million. It would take advantage of the growth of efficient electronic filing of tax returns to reduce the IRS processing budget by \$8 million next fiscal year.

Given we have had control over the budget for fewer than 5 months, the reductions that I have just described represent a first attempt to do more with less. As we begin work on the Budget for fiscal year 2011, Treasury has prepared itself for a more rigorous assessment of its spending.

I have already issued guidance to Treasury senior staff that says, in part: "To afford any new investments, we will have to take new approaches to solving old problems. I expect each bureau and policy office to identify opportunities for innovation

that will transform how Treasury fulfills its missions in order to both improve performance and reduce cost.”

In addition, the President has announced his intention to nominate Dan Tangherlini to be our Assistant Secretary for Management and Budget. Consistent with the President’s mandate, I will look to Mr. Tangherlini to scour the Treasury’s budget for efficiencies and cost savings. He comes to the job with an impressive track record of working on budget, management and performance issues with District of Columbia Mayor Adrian Fenty, and I am convinced that he will bring the same results-oriented approach to the Federal Government.

REPAIRING AND REFORMING THE FINANCIAL SYSTEM

The President has assigned the Treasury to repair key sectors of our economy so that they help revive growth and produce broadly shared prosperity.

The Treasury has been working to repair and reform every major element of our financial system, and to fill gaps in the system so that it benefits all Americans.

Last month, Federal banking supervisors announced results of the stress tests that we asked them to conduct on our 19 largest financial institutions. The aim of these assessments was to ensure that these institutions have sufficient capital buffers to absorb the losses that they could suffer under worse-than-expected economic conditions and continue to make the loans necessary to sustain recovery.

The clarity and transparency provided by the tests has helped improve market confidence in the banks, making it possible for them to collectively raise nearly \$90 billion through private equity offerings, bond issuances without Government guarantees and sales of business units.

On housing, Treasury is working with HUD to bolster our housing markets by helping to drive down mortgage interest rates and by assisting responsible homeowners to refinance into more affordable mortgages or modify their at-risk loans to avoid preventable foreclosures.

In terms of the non-bank financial sector, Treasury is working to revive critically important securitization markets for both new and old asset-backed securities.

We have begun to boost new consumer and business lending by re-starting the markets for asset-backed securities that financed almost half of all lending in this country before the crisis. There were more securities of this type issued the 4 months after we launched our effort than in the preceding 9.

Additionally, Treasury is about to join with private investors in seeking to restart the markets for legacy mortgage loans and securities that are now stuck on bank balance sheets, keeping these institutions from making new loans to families and businesses.

As we have made repairs to the financial system, we have understood that repair alone is not enough. We must also reform the system so that it is less prone to crises of the dimensions that we now face.

In the next few weeks, we will outline a comprehensive plan of reform that will include systemic risk regulations to ensure that no large and interconnected firm or market can take on so much risk that its failure could destabilize the entire financial system. The plan calls for bolstering consumer and investor protections. And it will streamline our out-of-date regulatory structure so that our regulatory system matches the size, shape and speed of our modern financial system. Together, these changes will help prevent another crisis of the magnitude that we have just lived through, and give the Government new tools to better cope with similar problems should they occur in the future.

In addition to the financial system, Treasury is helping to ensure that the Nation has a viable auto industry in the future. We are working with General Motors and Chrysler to make sure these companies make the changes necessary to again prosper. As President Obama has said “we cannot . . . must not . . . and will not let our auto industry simply vanish.”

The resources for administering key elements of both our financial and auto repair efforts were authorized by the Emergency Economic Stabilization Act.

These activities are being handled by our Office of Financial Stability (OFS), which is focused on ensuring that TARP funds serve the public purpose of economic and financial stabilization; that they are fulfilling this purpose in ways that protect taxpayers; and that we can provide a clear account to the Congress and the American people about the effectiveness of the funds’ use.

In order to administer TARP and ensure compliance by TARP recipients, OFS has had to quickly assemble a substantial staff. OFS staffing levels, which were at 88 when I arrived in office, had risen to approximately 165 by the end of last month and are expected to rise to 225 by next fiscal year. The office’s budget for next fiscal year will total \$262 million, a 6 percent decline from the current fiscal year’s \$279

million. The change is largely due to a decline in estimated spending on contracts as part of the program's initial start-up.

While TARP is proving effective at improving the immediate stability of the financial system, the scope of the issues that this administration and this Department face extend beyond TARP to include striking the delicate balance between intervention and allowing market participants latitude to operate; devising a new financial regulatory structure for the future; and working through the tough problems of what form our Government-sponsored enterprises, Fannie Mae and Freddie Mac, should take as we emerge from this difficult period.

All of these issues fall to Treasury's Office of Domestic Finance, which, together with OFS, is having to operate on new policy terrain, tackling problems that the country has not faced in generations and for which we have few guideposts in our immediate past.

That is why the workload of the Office Domestic Finance has already expanded greatly, and is all but certain to expand still further. And it is why we are seeking to modestly increase its size and bolster its expertise in several critical areas.

Our budget requests an additional \$8.7 million for the office to add 26 full-time equivalent (FTE) positions to the staff. This represents a 26 percent increase from the office's current fiscal year staffing of 101.

The additional funds will be used to create two new Deputy Assistant Secretary positions, one for housing finance, small business and consumer issues, and a second for capital markets. These two new officials will lead teams that will perform the economic and institutional research necessary to ensure that we understand all of the policy options in each of these areas and choose the most effective ones for solving our problems.

As we seek additional funds for Treasury, we must also seek them for the front-line institutions that will sustain our economic recovery and ensure that its benefits are broadly shared.

Our budget would more than double the resources of the Community Development Financial Institutions (CDFI) Fund to \$243.6 million. The fund's mandate is to help low-income, economically distressed communities that were poorly served by our financial system even in economic good times, and—although they had nothing to do with causing current conditions—have been significantly hurt by the economic and financial fallout of the crisis that we now face.

The \$136.6 million, or 128 percent increase in funding, would allow this program to support financial institutions in making job-creating investments and in providing access to capital in communities that are often considered too risky for mainstream financial institutions to serve. By targeting lenders and borrowers in these communities, the Fund would help some of our most vulnerable populations weather the crisis and benefit once recovery is underway.

The aim of the fund is to make sure that we provide distressed communities with more than simply Government grants and aid. We must also build the capacity of their local financial institutions to ensure that capital is flowing to homebuyers and businesses so that they can finance their own economic futures. Since its inception in 1994, the fund has directed nearly \$1 billion to distressed communities, and allocated \$19.5 billion in tax credits through its New Markets Tax Credit program.

Financial institutions funded through the CDFI program make loans to small businesses and micro-enterprises and take equity positions in them. They provide mortgages to low-income homebuyers, and finance developers of low-income housing and community facilities, such as charter schools, health clinics and child care centers.

One example can be seen right here in the Anacostia neighborhood of Washington, DC. City First Bank—a local CDFI—and Charter Schools Development Corporation partnered to provide a \$13.3 million New Markets Tax Credit for the Thurgood Marshall Academy, the city's first charter school focused on law, serving 360 students in grades 9 through 12 and achieving a 100 percent college acceptance rate for its first three graduating classes.

Historically, the CDFI program has been heavily oversubscribed and has had to turn away qualified applicants. For example, in the current fiscal year, the program for CDFI financial and technical assistance awards is budgeted at \$55 million, but it expects to receive applications for more than \$500 million in funding.

REDESIGNING THE TAX SYSTEM FOR FAIRNESS AND EFFICIENCY

The President has asked Treasury to redesign and bolster enforcement of our tax code so that it supports growth, sets the stage for our return to a sustainable fiscal path, and accomplishes these goals in a manner that is fair, efficient and supportive of our society's broadest goals.

To make good on the President's assignment, our budget requests a modest increase in funding for Treasury's Office of Tax Policy and more substantial increases to expand IRS enforcement activities and to improve its information technology.

Treasury has moved quickly in implementing the more than 30 tax provisions of the President's economic recovery plan. Treasury also has played an integral role in designing the tax provisions of the President's fiscal year 2010 budget, and it will play a similar role in implementing these.

The President has made clear that he will not seek any major revenue increases until 2011 when the recovery should be firmly in place. He has, however, been equally clear that once recovery is underway, we must get our fiscal house in order or risk having Government borrowing crowd out productive private investment. Treasury and the White House will work with Congress to make the tax changes that are necessary to reduce deficits and to do so in a manner that is fair to all Americans.

As part of our efforts to make sure that the tax system is working for recovery and is operating fairly, we have designed new policies to curb the use of off-shore tax havens, close the international tax gap, remove tax incentives for companies to shift jobs overseas, and replace these incentives with ones that encourage creation of jobs at home.

Our tax work on the recovery plan, the fiscal year 2010 budget, and these international tax issues are just the beginning of an ambitious agenda for this administration.

On healthcare, the President has made clear that the road to fiscal discipline and to solvency for Medicare and Social Security runs through overall healthcare reform. Although much of the cost of the President's reform plan will be covered by savings from the system, we will need to design programs to cover some of the costs in ways that are fair to all Americans and do not harm the economy. Treasury is deeply involved in this effort and in the related work to expand coverage and improve our healthcare system in other important ways.

On retirement and economic security, Treasury and, in particular, the Office of Tax Policy, is taking the lead in developing and actively working with Congress to flesh out the initiatives proposed in the President's budget to help enhance retirement security and savings for the half of working Americans who have no retirement provisions beyond Social Security. These proposals would make it easier for people to save for their own retirement, either through their workplaces or on their own, and would move us toward universal retirement savings coverage.

On climate change, Treasury is already working closely with Congress to design the auction mechanisms that will be needed to implement the administration's greenhouse gas cap-and-trade program.

Our Office of Tax Policy has been deeply involved in all of these issues from the outset of the administration. Like our Office of Domestic Finance, its workload already has substantially increased and is certain to grow as the health reform, retirement security and climate change debates get underway in earnest.

At the moment, the Office of Tax Policy's career staff includes 30 lawyers and 44 economists as well as support staff for an overall staffing level of 93. This is lower than its usual complement of over 100 professionals.

Our fiscal year 2010 budget would increase the office budget by \$4.9 million to add 15 full-time equivalent (FTE) positions in order to increase overall staffing to 108, and would therefore represent a return to historical norms. The additional staff is needed to perform analysis and revenue estimates for new policy proposals, conduct research for, among other things, congressionally mandated studies, and develop regulations and guidance for new legislation.

The vast majority of the new funds that we request in this budget are for improving the enforcement efforts and the information technology of the IRS.

As I have said, \$332 million would go to new IRS enforcement efforts, including \$128.1 million to improve international tax compliance. The balance of these funds would be used to support three critical programs: 755 employees to increase examinations of tax returns for businesses and high-income individuals; 300 employees to expand the IRS document matching program, which compares tax returns to other forms such as W-2s and 1099s; and an additional 491 employees to improve collection operations and build two new IRS automated collection center sites.

Turning to IT, our Budget requests a \$90 million increase in funding to protect taxpayers' personal records from the increasing number and sophistication of Internet-based attacks. With these funds, the agency will deploy state-of-the-art, automated tools to improve record access management, risk assessment and system auditing. This effort would address concerns noted in the past by both the Government Accountability Office and the Treasury Inspector General for Tax Administration.

Our budget also requests an additional \$18 million for systems to help the IRS return review program detect noncompliance and fraudulent refunds, and a \$22 million increase to continue modernizing the agency's core taxpayer account database and modernized the e-File web-based platform.

REENGAGING WITH THE WORLD ON ECONOMIC ISSUES

The President assigned Treasury to ensure that this country reengages with the world, not just on issues of war and peace, but also on the current crisis, and on issues crucial to our common economic futures.

This is a global crisis. Recovery here depends on recovery abroad. We are working closely with other major economies to put in place the fiscal stimulus and make the financial repairs necessary to ensure U.S. and global recovery.

The United States is seeking to mobilize the financial resources of the better-off nations to help the emerging and developing economies that have been especially hard-hit by this crisis. We are doing this for more than simply humanitarian reasons; as recently as last fall, these economies accounted for fully 42 percent of all U.S. exports.

Last month, the President and leaders of the other G-20 nations agreed on the need to make more than \$1 trillion in financial resources available to support global growth and trade.

Those funds include our commitment of up to \$100 billion for an expanded New Arrangements to Borrow, a permanent back-up mechanism that provides the International Monetary Fund with supplemental resources to help emerging markets and developing nations weather the crisis.

As part of our effort to rekindle global growth for the sake of our own recovery, we are seeking to meet our past and present financial commitments to the multilateral development banks that help emerging and developing countries.

Although the funds to do this are not directly within the purview of your Subcommittee, I mention them to illustrate how Treasury's entire budget is tailored to let us fulfill the missions that the President has set out for us. Our budget request includes \$2.5 billion for international programs, most of which would serve to meet our past and present commitments to the multilateral development banks.

Our financial reform effort in the United States must be matched by similarly strong efforts elsewhere in order to succeed.

CONCLUSION

Before I end, let me say a word about the Department's staff. I have the honor of leading a team of smart and dedicated individuals who are working to make our Government more effective and our society fairer, who are following a long tradition of debating policies fearlessly on their merits, doing what is right and not what is expedient, and drawing on the best ideas and expertise that are available. They are performing an incalculable service to our country in these challenging times, and I am immensely grateful to them.

The Department of the Treasury is responsible for promoting the Nation's economic prosperity and protecting its financial security. We advance our interests around the world through the strength not only of our economy but of our ideas.

This President and Treasury have already begun the hard work of recovery and reform. Our fiscal year 2010 budget will allow us to pursue these critical goals, and deliver the balanced and sustainable growth that the American people seek and deserve.

MORTGAGE FORECLOSURE

Senator DURBIN. Mr. Secretary, many of the questions we'll ask will be policy questions, somewhat global in scope. I will try to bring those home to the actual budget aspects of this hearing as best I can.

Let me start with a topic that you won't be surprised that I'm interested in, mortgage foreclosure. I have brought before the Senate, twice now unsuccessfully, an attempt to change the bankruptcy code so that we can create more incentives for renegotiating mortgages to avoid foreclosure. I failed in both efforts and, in the last effort, was opposed by virtually all of the banking institutions

of the United States, save one, Citigroup, that supported our efforts.

The Mortgage Bankers Association reported last week that about 12.07 percent of mortgage loans were delinquent or in foreclosure in the first quarter, the highest level ever recorded since the survey was launched in 1972. Also, for the first time, most mortgages in foreclosure were prime loans, 49.8 percent, compared to 43.2 percent subprime, which we initially identified as our major concern. Foreclosures bounced up 32 percent to 342,000 during the year over year period ending in April, according to Realty Trac.

The Obama administration's "Making Home Affordable" program has resulted in only 55,000 mortgage modifications in the last 2 months. According to The Washington Post, experts say foreclosure prevention programs will not be successful unless they address homeowners who owe more than their properties are worth.

I sense that this was the catalyst that led us into this recession. It is my feeling that the previous administration and, so far, this administration has failed to come up with an approach which is dramatically, could dramatically turn around this increasing number of mortgage foreclosures. A year ago, the estimate was 2 million, this year it's 8 million. Ultimately, one out of every six home mortgages faces foreclosure based on current predictions.

Do you agree that we need to strengthen incentives to modify more mortgages to turn this economy around? And wouldn't it help, wouldn't that help spur participation in the Treasury's own mortgage modification program? And can you suggest a better method to give homeowners more leverage than to change the bankruptcy code?

Secretary GEITHNER. Senator, you're right that housing is at the center of this crisis and, of course, millions of Americans are losing their homes, including many who were very responsible and are suffering simply because of the actions of those borrowers who lived way beyond their means and those banks that made a bunch of loans they should not have made.

And I agree with you that I think this Government should have moved earlier to address this crisis. We were late, as a country, and behind the curve. I do believe though that the President's program is a, does provide a very powerful set of incentives to induce a substantial increase in successful modifications. We are at the very early stage of implementing that program.

It's true we've been in office now almost 6 months, but—and this program was laid out, in terms of its detail, only a few months ago, but there is a substantial increase in efforts to put out notifications to potentially eligible borrowers and I expect to see a very substantial acceleration of the pace of modifications.

Now, this program does create significant incentives for servicers to participate. It also does reach homeowners that are significantly underwater. It won't reach all homeowners. There are some homeowners that simply borrowed—got themselves to the point where they've got a completely unsustainable mortgage and are unlikely to retain their house. But the program is designed to reach homeowners that are living today with significant amounts of negative LTV's, or high LTV's, negative equity.

Now, the program has been successful in helping bring down interest rates, working alongside the Fed. It has been successful in substantially increasing refinancing so that more Americans can take advantage of those lower rates and, as I said, we are just beginning to see the effects of these very substantial incentives we put in place to encourage modifications.

Realistically, I don't think we are going to know, until probably early fall, whether we've got the incentives right and whether they will prove powerful enough. But our judgment is that this is the best package of incentives which offers the best return for the taxpayer's resources we are going to use to help address the housing crisis.

Senator DURBIN. I would just say that I have asked this question of your predecessor; in perhaps a little different form, and still remain skeptical that the voluntary approach to mortgage renegotiation is going to save us from this crisis that we are facing.

I think, until we get an honest approach that really results in substantial renegotiation of mortgages, that the real estate industry and the housing industry are going to continue to be weak. I don't know how we can build a strong American economy if our homes are losing value and we see our neighbors facing foreclosure as we find across this country.

Secretary GEITHNER. Senator, I understand your concern and I commend you for your leadership and focus on this issue from an early perspective. But this program is a dramatically different program from what was tried in the previous administration. The financial incentives that we put in place here are very substantial. And it came alongside a substantial change in policies by Fannie and Freddie to help allow for refinancing, even for homeowners who were slightly underwater.

So, I think that we all want to see results. And you should judge us by our results. And it will take a little longer though to judge whether this is as powerful as we expect it to be. Now, I think if you just step back and look what's happened in the housing market over the last 6 months or so, partly because the effectiveness of the recovery program and confidence and partly because of the impact of the Fed's programs and the Treasury's programs, the pace of decline in house prices has started to slow. And that is early signs of us being able to look to the other side of this.

But realistically, I think you are going to still see a very challenging period ahead for many homeowners, many more Americans are still at risk of losing their homes and that's why we want these programs to work.

Senator DURBIN. Senator, I might say that each member will have 5 minutes and probably more than one go-round.

Senator Collins.

TRoubLED ASSEt RELIEF PROGRAM

Senator COLLINS. Thank you, Mr. Chairman.

Mr. Secretary, I want to follow-up on the discussion we had about the use of TARP funds. It troubles me that banks have received billions of dollars without having to demonstrate that they've increased lending as a result and without having to be fully

accountable and transparent in the expenditure of the funds they have received.

I mentioned to you that I've seen, in my State, a large recipient of TARP funding constrain credit, to actually cut off lines of credit, to cease lending to a nonprofit hospital in my State, and a major retailer.

So I don't see, on the grassroots level, the benefits of putting billions of dollars into financial institutions, the intent of which was to prevent this constrained credit. In addition, the Special Inspector General for TARP, in his report in April, criticized the Treasury for not adopting recommendations to require that all TARP recipients account for the use of the funds.

So, I'd like to ask you to comment on why the Treasury hasn't made, as conditions for receipt of TARP funds, requirement for increased lending and full transparency?

Secretary GEITHNER. Senator, excellent question. Could I just start by saying that we, you know—this is a crisis produced, in significant part, by two things.

One is, families across the country substantially increased the amount they borrowed. So household debt rose dramatically as a share of our overall economy. And we had pockets of excess leverage, too much lending buildup, across the financial system. Now we are going through a very deep recession. In any recession, the demand for credit falls because economic activity falls. In a recession that follows a long credit boom like this, you would normally have expected the credit to fall quite sharply. That's an important context because it's hard to know how best to measure the full impact of these programs. Because again, it would have been, under any circumstance, we would have had a period where borrowing would fall, as homeowners, as families decided to go back to living within their means, decide to save more, reduce their debt outstanding. And lending would fall as the weaker parts of the financial system decline to a more sustainable level.

Now, it is very important to us that we have better ways of measuring the impact of these programs. So when we came into office, we put in place a much more comprehensive reporting so that all banks that received TARP assistance have to report monthly on what is actually happening to lending behavior. We started with the major banks and we extended that out to all TARP recipients and you will be able to see monthly now, on the Treasury website, what banks are actually doing in terms of lending. And that is the ultimate measure of the impact of these capital assistance programs.

We are very committed to improving the overall quality, transparency, and accountability across these programs and each of the programs we have designed provides for an exceptionally careful level of oversight, and a level transparency so people can measure the actual impact and effects.

Now, if there are other things that we can do to strengthen that, we will do it. Because nothing is more important to the credibilities programs than a better sense among the American people that they have the chance to judge and measure impact.

Now, just to finish quickly, where do you begin. My own judgment is that the programs that the Congress authorized last fall,

and the actions that my predecessor took initially to put capital into the U.S. banking system, were absolutely essential to prevent a catastrophic financial collapse. If you look back to that period of time, lending absolutely stopped. And because lending stopped, and because confidence was so badly damaged, basic business stopped. And it happened around the world. And when that capital was put into those banks initially, that was the first step in beginning to lay a foundation for recovery and repair.

We cannot know with certainty what would have happened in the absence of that action, but my judgment is that, without those actions, you would have faced the prospect of a catastrophic failure in the U.S. financial system and much, much, more damage to economic activity than we already saw.

Now today, we're seeing, over the last several weeks, we are seeing some very impressive and encouraging signs of improvement in the overall credit conditions. So if you look at concern about risk and exposure to banks, and if you look at the ability of banks to go raise equity to replace the Government's investment, if you look at what's happening to the borrowing in businesses across the country. If you look at what's happening to mortgage rates, the interest rates, there have been substantial improvements in those basic measures of these programs. So, my sense it is early days, as I said, and this is just the beginning, but I think where the Government has acted, you can see very tangible benefits in improvement.

Now, we have a ways to go. This crisis took a long time, the conditions of this crisis took a long time to build up and it will take a long time to work through, but I think these programs are having, are achieving traction and they're the right mix of programs. And we will do everything we need to do to make sure that we are adopting sensible recommendations by not just the SIGTARP, but by the congressional oversight panel and the Government Accountability Office (GAO) who are looking very, very carefully at all these programs.

Senator COLLINS. Thank you.

Senator DURBIN. Senator Lautenberg.

EXECUTIVE COMPENSATION

Senator LAUTENBERG. Thank you, Chairman.

Mr. Geithner, the financial crisis that we're seeing was, in my view, due in significant part to the poor management of these companies and particularly I am pained by the outcome of the management years in the automobile industry who refused to see what the public appetite was, when we refused to be competitive, and thus jobs have been lost and an industry practically destroyed that we loved and admired for so many years.

When we look at the risks taken by corporate executives, decisions made, many of these executive pay packages insulate CEOs from the risk and, again, I may, I don't want to take you out of your bailiwick, but to avoid this excessive mismanagement, should executive compensation be tied to the long term health of the company? Where do we have a right to interject our views?

Secretary GEITHNER. Senator, this is a very important issue. And I agree with you that I think, although many things caused this

crisis, what happened to compensation and the incentives that created risk-taking did contribute in some institutions to the kind of vulnerability we saw in this financial crisis. And my view is that we need to help encourage substantial reforms in compensation structures, particularly in the financial industry because of the dependence of the economy on a well-functioning, more stable, better set of judgments by financial institutions.

I think boards of directors did not do a good job. I think shareholders did not do a good job in terms of disciplining compensation practices. And I think a centerpiece of sensible reforms would be to tie compensation to better measures of long-term investment and return and to adjust them to reflect the risk, to reflect risk. That's part of the reforms and we are, as part of our broader regulatory reform proposals, our proposals to reform the whole framework of renewed regulation in the United States, will include some suggestions for trying to encourage reform in compensation practices.

Senator LAUTENBERG. Where does the start begin? Is it in Treasury or is it IRS or the Securities and Exchange Commission (SEC)? How do we get things introduced into the governance of these things?

Secretary GEITHNER. Well, as you'll hear from us in the next few days, the SEC has some important responsibilities and obligations in this area and some tools and authorities they may seek in this area. The bank supervisors, under the leadership of Chairman Bernanke and others, have already initiated a process to define standards and principles that supervisors would use to help bring about reforms in compensation practices in the financial industry.

Those are two ways we can have influence over the shape of practice in these areas. There are other ways, too, but my own sense is that the core will be those two authorities.

Senator LAUTENBERG. Senator Nelson mentioned something about the Government owning shares in these companies and its, I think it has to happen. Who, for instance, would vote the shares? Would the Government be, the American Government, be likely to appoint the board of directors and have them make a decision?

Secretary GEITHNER. Senator, this is an enormously important set of questions. As we said before, the President and I have said, we are an extremely reluctant investor, an investor. We do not want to be in the business of managing these companies on a day-to-day basis. We would like to make sure that we have the ability to get out as quickly as we can and have these companies emerge on their own as viable entities without our assistance on an ongoing basis and the capacity to go raise capital in the markets to repay the Government's investments.

To underscore that, we are—we've designed a set of policies and mechanisms that will ensure that people understand we only intend to use our voting rights for a very limited number of core judgments about financial structures of the firm, to make sure that there's a strong board and management in place at the time that we take our equity investments so that the taxpayers' interests are protected. So we have confidence in their ability to oversee a sufficiently robust restructuring plan.

We do not want to leave the impression or the reality in place that the Government of the United States will, will be able to and

will have the capacity to exercise judgments over the day-to-day operations of these businesses. We think that would be damaging to franchise value, damaging to the interests of the taxpayers in trying to make sure that we can get out as quickly as possible. And our hope is that we design a set of institutional protections to avoid that risk.

Senator LAUTENBERG. Thank you, Mr. Chairman.

Senator DURBIN. Thank you. Senator Bond.

Senator BOND. Thank you very much, Mr. Chairman.

FAILED BANKING INSTITUTIONS

Mr. Secretary, a lot of us in the heartland are wondering why you are treating failed banking institutions differently from General Motors and Chrysler? The administration has orchestrated forcing car companies into bankruptcy, but they seem to be reluctant to force failed large financial institutions, like Citi, into restructuring. Now, we've seen in the past that large organizations, not as large as Citi, but IndyMac has gone through a Federal Deposit Insurance Corporation (FDIC) cleansing program and this one is outside of politics. And when you do it through the FDIC, you don't get the political questions that are asked, you don't get the political involvement in it. And, as The Wall Street Journal asked today, if Citi is not forced into an FDIC-like restructuring, you know, how can you ensure taxpayers that failed banks will not continue to return for billions and billions of bailouts, which I think all of us have heard great concerns from our constituents about.

Secretary GEITHNER. Senator, I share those concerns and I think it's important to acknowledge that the actions that the Government has had to take, over the last 12 months in particular, to help protect the economy from this financial crisis have created, well, they have been exceptional and extraordinary, and they have created the risk that, unless we reform the system, we are going to face a greater risk of financial crises in the future, because we will have created a moral hazard that might make the system more vulnerable in the future.

I am deeply worried about that, I share that concern. And that is why it is so important that we put in place stronger protections against constraints on risk taking in the future. A centerpiece of what the President will recommend, in terms of financial reform, will be a set of much more conservative set of constraints on risk taking across the financial system, more evenly enforced with a more effective oversight. And, as part of that, we need to have a better capacity to deal with potential failure of large institutions.

Now the system that you referred to, the system that the Congress helped to put into place, built around the FDIC, strengthening in the wake of the savings and loan (S&L) crisis, is a very effective process, but it was designed to deal with relatively small banks and thrifts and was it not designed for a crisis of this severity. That is why we do not have—and that system was not designed to deal with a more complex set of failures, for example like AIG.

That's why a centerpiece of what the President will recommend would be a stronger capacity to resolve, address, better manage the risks to the system posed by those types of institutions.

Now, I just want to underscore just a couple things about context. Now, when I came into office, the Government of the United States had already invested roughly \$200 billion in our Nation's banks. As I said to Senator Collins, I think that was a necessary thing to do. We would never want to do that, but it was the correct thing to do.

TOXIC ASSETS

Senator BOND. Mr. Secretary, I'm running out of time but I think everybody would agree, the Federal Reserve came up and flooded the system with money, we put—the TARP money in. But now we're past that. And unless we take some steps to deal with too-big-to-fail, we're going to have a moral hazard. And I'm also worried about the PPIPs, a lot of people saying that the banks aren't participating because it looks like it's going to be political. And if they get in—who would want to get in partnership with the Federal Government when they see what some of our fellow Members of Congress are doing?

Are you going to be able to get any of these toxic assets out with PPIP? Where are the participants?

Secretary GEITHNER. Senator, again, I want to underscore that you are right. This issue of too-big-to-fail moral hazard is a really important thing. And that's why the President wants to move so quickly on legislation.

Now on the issue of these legacy assets, that are still on the books of the Nation's banks. You're right that there is some concern in the market still about participation and whether that brings some risk of political conditions imposed in the future. And that could limit participation in the beginning and that would be an unfortunate thing. I think we all have a responsibility to act to reduce that sense of risk and uncertainty about the rules of the game.

It's also true that banks have found it more easy to raise equity than they thought. And that, combined with a slight improvement in confidence in the system, may also reduce participation. In my judgment though, these funds still are an important part of the necessary framework of tools to help get our country through this crisis. And I believe it is important that we go ahead and put them in place, even if we see participation somewhat more limited than people would have expected because of both the political concerns and because the basic improvement—

Senator BOND. I would hope that we would use the FDIC model I and others and Senator Dodd have proposed, beefing up the FDIC, we need to use them. And I'll have further questions for the record.

And Mr. Chairman, I would ask that my full statement and all of my good advice in it be included in the record, in the hopes that somebody might read it someday.

Senator DURBIN. Well, we'll look forward to reading that and it will gladly be inserted. Thank you, Senator Bond.

Senator Nelson.

AUTOMOBILE INDUSTRY

Senator NELSON. Thank you, Mr. Chairman. Secretary Geithner, you mentioned that we are reluctantly in a position of holding the shares of General Motors and perhaps in a position of controlling other institutions, but we are doing so reluctantly.

I am so reluctant to be one of those holders of that stock that I am introducing a resolution, as a sense of the Senate resolution, that we begin the process to divest ourselves of that stock ownership over a reasonable period of time, making clear that we are only a temporary shareholder and that we should take obviously all steps to protect the American taxpayer dollars and begin to divest the ownership as expeditiously as possible and call for a GAO study to help determine the period of time that it may take to return General Motors and Chrysler to solvency and complete the divestiture.

I think that says what I would like to say. In addition, I've heard it said that, for those who worry that somehow we are drifting into socialism, that socialism is where the Government wants to take over profitable ventures, as opposed to being where we are right now.

Apart from the levity, I think it is probably accurate. And so I hope that the administration will be supportive of every effort to make public statements that this is a temporary situation, not one that is optimum or optimal in terms of what we would prefer to do, but where we are at the moment but to make certain also that we are not going to stay there one day longer than we should in that position of ownership.

And I'm encouraged where you say that we won't exercise day-to-day judgment over many of the decisions and opportunities that the industry will have.

I've got some other questions about that and that relates to the dealerships. I know they're very concerned about summarily being dismissed after decades of relationships with the auto industry. Is there any effort to try to establish some sort of a recognition of the rights, and not just contractual rights, but the rights of dealerships in this dismissal where any compensation is being directed toward those dealerships to soften the blows?

It's not taking their position that is so important, it is recognizing that, in small communities all across America, particularly Nebraska, where dealerships are going to be lost, people are going to lose their jobs as well. In small communities where job replacement can be even more difficult than in the urban centers. I wish you might comment on that.

Secretary GEITHNER. Senator, can I just begin where you began to say, and I think you said it right, in terms of the Government stake in these entities, where we take a stake, temporary, clear path to exit, not a day longer than is necessary, no ongoing role in day-to-day management.

And, in that context, this broader question about the impact of communities of the substantial reduction in dealerships that the automobile companies have decided was necessary to get back on the path of viability. I just want to underscore that these were their judgments, based on a careful analysis of what was necessary,

again, to get them down to a cost basis that was more attainable over time.

But I understand the concern about the impact and would be happy to explore with you and talk to my colleagues about—to make sure you have responses to your thoughtful questions about with the companies themselves might be able to do to help to soften the blow.

Senator NELSON. I appreciate that. Thank you.

Secretary GEITHNER. But it has to be their judgment——

FINANCIAL REGULATORY REFORM

Senator NELSON. Of course, of course.

In terms of financial regulation, can you give us a preview of what you have planned for financial regulation? For example, are there any plans to change the State-based regulation of insurance? Will you propose an Office of Insurance Information or a similar position or will you seek authority to regulate insurance at the Federal level?

Secretary GEITHNER. Senator, I don't want to get ahead of the President of the United States on this. He is going to layout a comprehensive set a proposals next week. In that context, we will lay out our judgment about what we think is the most practical way to help begin the process of ensuring more effective supervision of at least parts of our insurance industry. But I don't want to get out in front of him. But we'll be taking a careful look at what is the most practical way to help to begin that, begin progress against the objective.

Senator NELSON. Well, as you take a look at the case of AIG, although it's an insurance holding operation, keep in mind that the insurance subsidiaries were profitable. That they didn't have bad assets. That this is not, this is not something that has rippled through the insurance industry. But focus on what happened with the Glass-Steagall modifications that permitted AIG to do what it did.

And so let's don't cure problems that don't exist as we try to take a "comprehensive approach". Let's just make sure that it is not so comprehensive that the sweep in regulatory schemes and mechanisms that are currently working.

Secretary GEITHNER. Senator, I completely agree and we are bringing a broader pragmatic spirit to this exercise and try to focus on things that were central to the crisis, not things that were not. On things that are necessary to do, not just those, not those that would be desirable to achieve over time.

Now, we may not all agree on the judgments we're making, but that's the pragmatic framework we're trying to make.

Senator NELSON. Apparently, you are making a commitment not to have collateral damage, right?

Secretary GEITHNER. Well, that is something of an obligation that we all share and we would be very careful to try to avoid that, but Senator we did have really systematic failures across the regulatory framework of the United States and we are going to have to change a lot of things to address those failures.

Senator NELSON. Thank you. Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Nelson. Senator Tester.

TROUBLED ASSET RELIEF PROGRAM: RESERVE FUND

Senator TESTER. Thank you, Mr. Chairman.

So many questions, so little time. Secretary Geithner, in your budget there's a financial stabilization reserve of \$250 million. In front of the Banking Committee last week, Herb Allison was there. He is going to oversee the TARP, hopefully. He talked about, he called it head room, I interpret it as being reserve, of \$100 billion. Can you tell me why we need \$250 million in the budget?

Secretary GEITHNER. Senator, could I just begin by saying that I announced this morning that banks have, we've indicated to banks, the Fed indicated to banks that they have the right to repurchase \$68 billion, return \$68 billion of those initial investments and those will be coming back into the general fund. Now the way the EES legislation is designed, that does create additional flexibility to allow us to use those funds, if we believe there's a strong, compelling case. And since were—things are getting better in the financial system, I think, to be realistic, there's a lot of risk ahead for us and we need to be careful, to remind people that that flexibility authority is important.

Now, in the reserve fund. The President put in the budget this additional reserve fund, in an abundance of caution, against the possibility that we could face a deepening crisis. Now, we do not expect, at this time, to come back to Congress to ask for authority to use those resources.

I began by pointing out the \$68 billion repayment thing, because it does provide some modest encouragement, I think, that we are going to be able to get through this without having to put you in the position of coming back for substantial additional funds.

Senator TESTER. We appreciate that. I guess the question is out of \$700 billion, \$250 million, even though it's a ton of money, is like spitting in the ocean.

Secretary GEITHNER. Well, you're right. We are a \$14 trillion economy. This is a very severe financial crisis, the worst in generations, and financial crises are expensive to solve, particularly if you wait to solve them.

Senator TESTER. All right. I interpret by your answer to the last question that you anticipate the money that is going to be paid back will go into the general fund and not reinvested in the troubled banks.

Secretary GEITHNER. By law, it goes to the general fund but it also goes, as the law is written, and I think this was wise, it does give us flexibility to use that, again, if we think there's a compelling case.

EXTENSION OF TROUBLED ASSET RELIEF PROGRAM

Senator TESTER. Okay. In the end—well, you have an opportunity to extended it to the fall of 2010, the TARP program.

Secretary GEITHNER. We do.

Senator TESTER. Do you anticipate that that trigger will be asked for?

Secretary GEITHNER. I don't know at this stage. There's a range of exceptional programs we put in place, as Senator Collins just said, and some of them expire at the end of October and some of

them have a longer fuse on them. Some of them can be extended. We will have to make that judgment as we get a little more—

Senator TESTER. If you ask for an extension, I assume it applies to all the money and not just a portion? Is that correct?

Secretary GEITHNER. That's right. The way the law is structured, the authority is about the \$700 billion and it applies to the full \$700 billion.

TRANSPARENCY OF THE TROUBLED ASSET RELIEF PROGRAM

Senator TESTER. Okay. You talked about, and it has been referenced before, about reluctant investor, not involved in day-to-day decisions. It has been pointed out to me that some of the TARP funds are being used by banks for speculation in the oil market and the commodities market. Is there enough transparency now that they are using the TARP funds for you to know that?

Secretary GEITHNER. Well, I think that's really a question that I would have to refer to the supervisors. The supervisors of those banks that receive assistance have the full capacity to judge what kind of risk they're taking generally and whether those risks are appropriate, given the conditions of the—

Senator TESTER. I know you don't want to be day-to-day, and I don't want you to be in on the day-to-day decisions. The question is, do you think that's an appropriate use of TARP monies?

Secretary GEITHNER. Look, I want to make a big distinction between banks and others. Banks, because the risks they pose to the economy and because of the protections they enjoy, they are subject to a very intensive level of supervision and regulation by the Nation's banking authorities. That was not strong enough in some cases and needs to be stronger, but that is a perfectly legitimate public policy interest because of the interest of the system. So, I would distinguish that from the role of the Government as temporary shareholder.

Senator TESTER. Okay. In the previous question, you said that, as far as closing down dealerships, that was their decision. Who is they?

Secretary GEITHNER. The companies themselves. And their boards.

Senator TESTER. Okay. In the plan for General Motors, the investment of billions of dollars into that, were there any assurances that they wouldn't move manufacturing overseas?

Secretary GEITHNER. In the context of General Motors, the company has publicly committed to lay down a path for production in the United States as a share of total production. And in those plans, they've indicated that they expect production to be maintained at current levels, and perhaps expand slightly as they build this new plan for small cars.

So their plans now are, and these were part of the framework established for a bunch of reasons, they expect production in the United States to not just level off, but to expand slightly.

Senator TESTER. Okay. Thank you.

REPAYMENTS UNDER THE TROUBLED ASSET RELIEF PROGRAM

Senator DURBIN. Thanks, Senator Tester. Going back to the repayment of TARP, which is \$68 billion which was announced this morning. What is the expected return on investment for taxpayers?

Secretary GEITHNER. The way the terms were initially established, these preferred investments came with a 5 percent coupon. I don't have my press statement with me, but the Treasury has already earned several billion dollars in terms of those dividend payments on the preferred.

Now, the full terms for the Government include the value of the warrants that Treasury took as part of these investments. We are in the process of going through a judgment about what fair market value for those warrants is likely to be and in the release we put out this morning, I'm not sure we made an estimate, but some of the estimates now are in the several billion dollar range for those initial banks that are repaying.

Government—so people will bring all sorts of financial prisms to judge the return, of course you have to look at the returns to the country, not just in terms of the direct financial returns to country which are significant. They really are significant. But you have to look at the broader benefit in avoiding a financial collapse because there is dramatically more credit available today than there would have been if these banks were forced to shrink dramatically.

Senator DURBIN. That's the second question. Assuming that you wouldn't allow repayment, if there's any question of soundness in the institution, what kind of assurance do we have that these banks that return this money are going to be issuing credit, which was one of the original goals?

Secretary GEITHNER. Right. Well, the judgment on the law was made by the Federal banking industry's responsible, so they did a very careful process of judging whether they really could prudently repay this money. And the figure I announced this morning reflects the judgment of the Federal banking agencies. That means these banks are in the position now where they can make normal business judgments about lending. And I think, by many measures, lending is very—expanding credit is a very economic thing to do today.

But as I said, we are in recession that followed a huge boom in credit. So it's going to be, for many parts, many families, many businesses, borrowing will decline as we go through this. And that is a healthy, necessary thing. It makes it very hard to judge, because you don't know what would have happened in the absence of investments, what lending would have been produced.

But I think you have a different financial system today that is substantially stronger than it was 2, 3, 6, 9 months ago and is in a much better position to provide the credit necessary to help us get through this recession and to get back on a growth path again.

CREDIT CARD INTERCHANGE FEES

Senator DURBIN. Mr. Secretary, we recently enacted or passed in the Senate an historic credit card reform bill, which I commend my colleague, Senator Dodd, although the Banking Committee worked

so hard on it. It's been 25 years or more since we've done anything in that field.

There was the third rail in this discussion which we couldn't bring up and couldn't discuss for fear it would explode the whole process, interchange fees. Interchange fees are the fees that are charged by credit card companies and imposed on retailers, and there's very little room, when it comes to the retailers, to negotiate these fees. Approximately 2 percent of our purchases using credit cards are paid back to the credit card company in interchange fees and the retail establishments across America are very concerned about this because they have little or no voice in that.

I'd like to ask you two questions about interchange fees. First is a more general question about what the Treasury is doing, if anything, to look into the interchange fee system.

But then, in particular, since it turns out that the Federal Government is now accepting credit cards, it turns out that there are 200 Federal entities that accept credit cards, Amtrak, the Postal Service, the Treasury's financial management services, it turns out that our Government paid these credit card companies over \$200 million in interchange fees to Visa and MasterCard, in fiscal year 2007.

I have repeatedly asked the credit card industry and the banks to demonstrate that the rates that they've established are legitimate to process the card transactions and unfortunately they have not been able to provide any data or information to suggest that the amount charged, even to the Federal Government, represents a reasonable fee. In fact, the GAO report on this recently said that the FMS tried to negotiate lower interchange fees with Visa and MasterCard and negotiations were not successful.

So, in addition to the general question of interchange fees on retail establishments across America, what is the status of your effort to make sure that Uncle Sam isn't paying too much to these credit card companies for the use of the credit cards?

Secretary GEITHNER. Senator, this is a very complicated question and, to be honest with you, I have not thought about this very much yet. But I would be happy to spend some time with you and your staff, understanding your concerns about this and taking a careful look at both questions you raised.

If I'm not mistaken, I think you asked the GAO to do a study of one of these dimensions and of course we would look carefully at the conclusion of this study. But I am happy to commit to spend some time on this and see if we can—see if there are some sensible things that we can do to protect the Government's interests, not just to address the broader reform question you raised.

STAFFING OF THE TROUBLED ASSET RELIEF PROGRAM

Senator DURBIN. If Senator Collins would just bear with me for one more question. I think, with the establishment of TARP under the previous administration and the continuance under this administration, there has been a shift of personnel within the Department of the Treasury to deal with the obvious demands, administrative demands.

Can you give me a general impression of whether or not this has created dislocations in other parts of the Treasury Department

which need to be addressed and whether the repayment or the pay-back on these TARP funds is some indication that we be getting out of this business and can get back to business as normal?

Secretary GEITHNER. The way that the EESA legislation was written it provided funding for the administrative resources required to design and run these programs and we have substantially increased resources, using that authority, to staff that part of Treasury, the Office of Financial Stability.

But we are also going to have to increase, as we proposed in the budget, the rest of the domestic finance staff. Because they have got this greatly expanded, much more complicated set of challenges in a range of policies, including the one you just raised. And we did announce several weeks ago the appointment of a new Deputy Assistant Secretary for Consumer Policy Issues in the financial sector.

I do not believe that we've had to devote resources from other parts of the Government to these financial crisis imperatives on a scale that would jeopardize our capacity to carry out those broader responsibilities. And we will be very careful to avoid that risk. But there are parts of the Treasury, as I suggested, where we think that we are going to need to have some modest increases in baseline, like tax policy, which is outside of domestic finance. And I think, with that support, I think we will be in a stronger position to meet these broader objectives.

But my basic answer to your question is, no, I'm not concerned now that we've had a substantial diversion of resources, as important as the financial crisis is, at the expense of other core priorities of the Government.

Senator DURBIN. Senator Collins.

AUTOMOBILE DEALERSHIP TERMINATIONS

Senator COLLINS. Thank you, Mr. Chairman.

Mr. Secretary, I want to follow up on the questions that Senator Nelson asked you with regard to the decision of General Motors and Chrysler to terminate dealerships.

This decision has been perplexing to many of the automobile dealers in my State. Everyone understands that General Motors and Chrysler have to restructure and shed costs in order to survive, but the dealerships in Maine tell me that they pay for the cars, that they pay for the shipping, that they own their own showrooms, and they pay for their sales people. So, they've raise the question of how does this save money for the automobile manufacturers to have fewer people promoting their products? Could you shed some light on this for us?

Secretary GEITHNER. Senator, that is an excellent question and I have spent some time, I've never run an automobile company, but I've spent some time trying to—

Senator COLLINS. Until now.

Secretary GEITHNER. I don't expect to be running one now either. But I've spent some time looking at this and I guess I would say, I'm not sure this is going to be convincing or persuasive to you, but if you look at the broad consensus, people who looked at what was going to be necessary to put these companies back on a better financial foundation, I think there is a very broad consensus that, to do that, they need to get the distribution costs down and the dis-

tribution system more efficient. And that's why the companies themselves, at the center of their plans, have proposed very substantial reduction in the number of dealers.

Now, I know that it's—I'm not sure that's persuasive, but my sense, again, in reading a bunch of and listening to people who study these companies look at them and say, a very broad sense, that this is a part of, an important part, to get them down to a cost basis to allow them to be viable. Now that comes with enormous damage in those communities, and it is a wrenching adjustment, but the reality is that these restructuring programs will leave the country with many, many more dealers than what would have existed in the absence of these programs.

The balance, it may not be perfect, but I think that my sense in looking at it is that this is a necessary part of their efforts to get back to a path where they don't need the Government.

Senator COLLINS. Was the decision to reduce dealerships made by the manufacturers or was it imposed upon them by the auto industry task force?

Secretary GEITHNER. It was not imposed by the auto industry task force. It was a judgment made by those boards of directors and their management, again, about what was a critical part of a restructuring plan.

Senator COLLINS. Thank you.

FINANCIAL REGULATORY REFORM

I'd like now to return to the issue of financial regulatory reform. I introduced a bill in March to create a council of regulators to act as a systemic risk monitor. I know that the other model for that is to have the Federal Reserve assume that responsibility. I think there's widespread consensus that we do need to have a systemic risk monitor so that someone, or some entity, is looking across the financial system and identifying high-risk practices, policies, or products and regulatory black holes, so that we don't have the problem of no one regulating faulty credit or swaps or the next product that comes along.

The reason that I support the council is I believe there's value in bringing many perspectives to the table and many areas of expertise. The Fed frankly has its hands full. There are also issues about congressional oversight. We want the Federal Reserve to be independent in order to set monetary policy. If it's also going to be the systemic risk monitor, there's going to have to be more congressional oversight of its operations.

So tell me, I know you don't want to precede the President in announcing his plan, but discuss with me the pros and cons of the two approaches.

Secretary GEITHNER. Well, I should begin by saying, although I am not going to get ahead of the President, that we share many of the objectives you laid out.

I think a necessary part of the solution for the U.S. financial system will be a more effective body to bring together the responsible supervisory agencies, alongside the Fed, to make sure we are looking across the system as a whole, that we are keeping abreast of changes in the structure of the system so that we can better limit

the risk in the system. And I think a council has a lot of merits in that context.

And I don't believe it is necessarily desirable for us to concentrate all authority for dealing with the future risk of the system in one part of our complicated governmental structure.

So, although we are going to propose some important streamlining consolidation simplification of the oversight regime, we are not going to propose to concentrate all the authority for systemic issues in only one place. It's too complicated really to do that.

I think the really important thing is, again, is that we have more effective oversight over the core institutions that are critical to the system, that we bring critical markets like derivatives under an effective framework of oversight and protections there, that we have much better enforcement with tougher rules for enforcement for consumer investor protection. That we have better tools for managing future crises. And we are going to have to have tougher constraints on risk-taking involving better constraints on leverage and capital, so that you have thicker shock absorbers, thicker cushions against future crises. We are more able to let firms fail. The system is more robust to potential failure.

So, those are broader objectives in our approach. But you'll find many of the concerns and objectives you laid out present in our recommendations.

Senator COLLINS. Thank you.

Senator DURBIN. Senator Tester.

TERMINATION OF AUTOMOBILE DEALERSHIPS

Senator TESTER. Thank you, Mr. Chairman. I don't want to beat this horse, but I will just say this. And I like ya. There's an overwhelming attitude in this country that bigger is better. And I think what we're allowing General Motors and Chrysler to do, by closing down these small dealerships, is putting all the forces into a few big dealerships because, number one, it is easier to deal with a few people than it is a lot. And number two, it will reduce competition. And I've got to tell ya, if the dealership is making money, I don't see any criteria for shutting them down. And that's my only editorial comment I will tell you.

And the only other thing to keep in mind is, in rural America, it's a heck of a lot different than it is in urban America. You shut down some of these smaller dealerships in some of these small towns that are making money, that General Motors is making money off of, its going to have an incredible impact on the economy. That's all. And I know you aren't making that decision, but if you could pass that along to the powers that be, I would appreciate it.

Secretary GEITHNER. Message heard and received.

Senator TESTER. Okay. Thank you.

FEDERAL DEFICITS

Chairman Bernanke talked restoring fiscal balance. Could you just comment on that and where you see us going over the next few years, assuming the economy gets turned around?

Secretary GEITHNER. It is critically important for this country, it's central to the prospects of recovery, that we put in place a

framework that gives confidence to Americans and investors around the world, that we are going to have the ability, the will and ability, to bring our fiscal deficits down to a sustainable position over the medium term. And that's why the President, in his initial budget, laid a path for dramatic reductions in the deficit to bring them down over a 5-year period to a level at which our overall debt is not growing and can start to come down.

Senator TESTER. I just heard the Government will triple in 10 years not more than one-half an hour ago.

Secretary GEITHNER. Well, you know, we came into—I last served in the administration during the period where we had an extraordinary accomplished record of fiscal discipline, produced surpluses, helped bring down interest rates, helped lay the foundation for not just a strong dollar but an incredibly long period of private investment growth, productivity growth. So, I am a deep believer in and have deep conviction in the central importance of fiscal responsibility for this country.

Now, we started this year in the worst financial crisis in decades and, because of that crisis and the damage done by the financial system, we had to do, with the Congress, extraordinary things. And those, by necessity, produced a short-term temporary increase in our deficits. There was no path through this crisis that did not involve some temporary short-term increase in borrowing. But at the time that we proposed and, again, the President proposed and he acknowledged that we were going to have to bring this deficit down over time and that's what we're going to do with the Congress, it is going to be difficult to do, and it is going to be important to do, because, again, we are going to find that recovery will be weaker, private investment will be weaker, interest rates will be higher unless we are able to convince people that we're going to have the will and ability to do that.

FINANCIAL REGULATORY REFORM

Senator TESTER. Okay. Too-big-to-fail. It can't be an option in any industry and I think we may be there in energy and we may be there in food systems. We are absolutely there in the banking industry. How do we fix it? Do we fix it with regulation? How do we fix it?

Secretary GEITHNER. I think there are, I would just mention a few things and they will be the core of what the President lays out soon.

First, you have to have better design, tougher constraints on leverage, on risk taking in the core parts of the system. You have to have better oversight of the central markets like derivatives, because those are the markets that sort of effect whether failure is going to risk wrecking the system or whether failure can be absorbed and accommodated. So you need thicker shock absorbers in those central market, too.

You need resolution authority, as I said in response to Senator Bond's comments, that allows us to deal with the perspective failure of a large complex institution like AIG. Those are some of the things you need.

And I would just make one observation, Senator, just to show how hard and complex this is. It's not just the size. And in some

ways size is not the most important factor. It is the role the firm plays in the system, how connected it is, what impact its failure has. And you've had, in this crisis, what are not the largest institution in the world, present the risk of catastrophic damage because of how interconnected they are.

So, better capital applied across the system to limit scale of leverage, much better oversight and shock absorbers in the central infrastructure to limit the risk of damage caused by failure and better resolution tools.

Senator TESTER. Okay. I want to step back, step back for just a second. Neel Kashkari said that that the big guys had an advantage over the community banks in particular, because of their access to credit due mainly to TARP, I would imagine. Do you think that they have an unfair advantage and—

Secretary GEITHNER. I don't, I don't—you know, we have 9,000 banks in this country. I expect that, 10 years from now, we will still have a financial system, and it is very important that we have a financial system, that has thousands and thousands of small community banks operating across the country. I think that makes our system more resilient and stronger and I think this crisis would have been worse without that. And one of the importance of the reforms that we are going to layout is to make sure that large institutions have constraints on leverage that are appropriate, given their scale and risk. And that will help offset some of the potential concerns you raised about a level playing field for community banks.

Senator TESTER. Thank you very much.

FINANCIAL PRODUCT SAFETY COMMISSION PROPOSAL

Senator DURBIN. Mr. Secretary, I was glad the President announced the support for the concept of a Financial Product Safety Commission. I first introduced that bill in March and I think that to have an agency charged with protecting consumers from predatory tricks and traps is a good idea and could have spared us some of the problems we are currently going through with prepayment penalties on mortgages, for example.

But, in a way that is the easy part of my question. The tougher part gets to the heart of the issue and the heart of the issue would be an interest rate charge. Is there too much, is there an interest rate that is too high in America? Do we have an obligation as a country to say that certain levels of interest rates are unconscionable, intolerable, illegal, unacceptable?

I put in a bill to put the usury rates at 36 percent because I thought that was so high that we would be just fine. As I said, if you wanted to start a snake farm, you should put in a usury bill and watch what crawls under your door. The folks that came from title loans and payday loans could sit and say to me, with a straight face, Senator, you're going to put us out of business. Thirty-six percent will put you out of business? Yes. I asked them how much do you charge for loans? Oh, somewhere between 58 percent and 800 percent. People used to go to prison, they called it juice in the old days, when people were engaged in that sort of thing, you know, in the back alleys. Now it is acceptable, legal in this country.

Is there, should there be a consideration about limiting interest rates charged for certain products in America?

Secretary GEITHNER. Senator, I believe that we have to have a much stronger set of protections for consumers, particularly in the area of financial products that involve debt and credit. Those were where the failures were the most stark and I think it is going to require more than institutional and I agree with you, just establishing a commission doesn't, it just doesn't—it may be necessary but it is not sufficient.

So, I think you need to have stronger protections. I think the credit card reform bill is a good step, but it is a not a sufficient step. And we're going to propose what we believe and the President believes is a necessary set of much stronger protections.

Now, I understand your, the reason why you're supportive of a cap on interest rates. You have been exposed to a lot of the concerns on the other side of that, in terms of that would have unintended effects, in terms of denying people the rights to some forms of credit. I think you're right, it's sort of hard to make the case as to why some of those products are necessary or desirable, but I do not believe that those caps are a necessary part of a strong, credible consumer protection regime. And what I suggest is, I hope that when we lay out our proposals, we will have a chance to look at those and talk to you about whether those go far enough to meet your concerns.

USURY CAP

Senator DURBIN. Can I ask you to also consider the following? If we can't sell the notion of a usury cap, shouldn't we prevail upon institutions? I mean, credit unions have been coming to me for over two decades saying we're different, we're not greedy like banks, we're just trying to serve our little group of people that save there and we loan to them.

Shouldn't we be talking about making credit available to the poor people who are lured into these payday loans and title loans? Have credit available in lower amounts at reasonable interest rates so that these people are not exploited? I just don't think we can continue to look the other way. I have challenged the credit unions to do it, they haven't responded.

But perhaps the banks bear some responsibility here. If we are going to have credit available for people who are truly struggling in this economy, why do we throw them to the wolves with these payday loans and title loans?

Secretary GEITHNER. I agree. I think people who have spent their lives, like you, thinking about these issues believe that an important part of the solution is to make sure that all our citizens feel that they have the capacity to be part of the broader financial system that has these protections. And one step toward the objective you laid out is to make sure that they have bank accounts, have a relationship that allows them access credit which is going to be on forms where they are less vulnerable—I think that's an important thing.

The President's nominee for Assistant Secretary for Financial Institutions at the Treasury, his name is Michael Barr, has spent his life's work on these kinds of questions and he is one of the more

thoughtful people in the country thinking about to bring about reform in those areas.

Senator DURBIN. Thank you. Senator Collins.

REGULATORY REFORM

Senator COLLINS. Thank you, Mr. Chairman.

Mr. Secretary, another issue that keeps coming up is regulatory shopping. In other words, financial institutions will figure out which regulator gives them the most advantages. I saw this on the State level 20 years ago where we would have a financial institution come in and threaten to switch to a Federal charter because our audits were too tough or our consumer protections were too strong.

I don't think that it's a coincidence that AIG bought a small federally chartered thrift, or established a small federally chartered thrift, in order to get under the regulation of the Office of Thrift Supervision, OTS, which is generally viewed as being a weaker regulator than the Comptroller of the Currency.

Are you looking, as part of your reforms, on combining the OTS with the OCC? That's what my bill does. And needless to say, I think it's a brilliant idea and needs to be done.

Secretary GEITHNER. Senator, you're absolutely right that one of those things that helped produce this crisis was that, in our country, we allowed people to choose their regulator, to put risk in areas where they thought it was going to be least well-regulated, and that level of unevenness in the basic standards and protections in our system proved tragically damaging to the stability of our system. And fixing that will be critically important.

And, as part of that, we are looking at the areas in our system where we are most vulnerable to that kind of shopping for regulators and regulatory arbitrage. You pointed out one example, and I think it is one the more compelling examples, of that failure and weakness in our system. But just to say that we're looking beyond that. Of course, we're looking at that, but we know that this is something that we need to do globally, too. Because we need to make sure that we're not vulnerable in the future to risks if we get the standards better here, risks just moving offshore to other areas where there is still risk to our system. So, we want to have a level playing field, more conservatively set, more evenly enforced across the U.S. financial system. And we want to try to bring the world to those higher standards as well.

Senator COLLINS. You know, you also made an excellent point when you talked about the excessive leverage in the system. I think when Bear Stearns failed, its leverage ratio was an astonishing 30:1. That's something that never would have been allowed to happen under our regulatory process for a small community bank or a credit union.

So, I hope, as you look at this issue, that we're going to be establishing safety and soundness requirements regardless of the type of institution. It seems to me that Bear Stearns, the larger investment banks, all of which have either disappeared, have been acquired, or no longer exist, should have been required to meet the same kinds of capital requirements and leverage ratios that we would impose upon a community bank or a credit union.

Secretary GEITHNER. Senator, I have a lot of sympathy for that view and I think that, again, a centerpiece of what we need to do for this country is to make sure there are more conservative, better designed constraints on leverage applied more evenly across those institutions that play a critical role in how our markets function, both in normal times and in distress.

Now, it is true that, in the United States, we were fortunate to have, across the banking system, a very simple, easily enforceable, crude constraint on leverage. And for that reason, in many ways our financial troubles today are much less acute than they are for countries around the world where that kind of constraint did not exist.

So just an example, banking assets in our country today about one times gross domestic product (GDP). They are between two and eight times GDP across Europe. In part because they did not have in place that kind of simple, crude constraint on leverage. So, you are right. That is an important part of the reform. We want to have, as I say, thicker shock absorbers in the system, thicker cushions of capital against risk, that are more simple, more evenly enforced, and are less pro-cyclical, you know, that they dampen future crises rather than amplify them. And that would be a part of what we propose.

Now, I want to just say that these are things that—these are very complicated things. Of course, we want to get them right. And we are going to go through a very careful process to bring experts together and thinking about what the right mix of those constraints are so that we have them in place before we start to see the seeds of next boom.

Senator COLLINS. If you haven't already looked at them, I would encourage you to look at the Canadian and the Australian twin peaks system, which I think also have benefits to them.

Canada has not had the kind of financial crisis that we've had, and it is very interesting to look at the differences in their regulatory structure, their mortgage lending, and their tax deductions. It's fascinating to look at those differences and then look at the results.

My time has expired, so I am going to submit for the record, with the chairman's permission, some questions on our debt level because I wasn't able to get to that important issue today.

Thank you.

Senator DURBIN. Of course, Senator Collins, your questions will be submitted for the Secretary, along with others, for him to consider.

The last question will come from an organic farmer from Montana, Senator Tester.

STRESS TESTS AND ECONOMIC RECOVERY

Senator TESTER. Thanks, Mr. Chairman. The Congressional Oversight Board issued a report this morning stating that additional stress tests may be necessary due to uncertain economic conditions. What are your thoughts on that?

Secretary GEITHNER. Yeah. I haven't had a chance to look at the report, but of course I'll look at it and read it. But I did see some of the initial coverage of the report.

I think I should say that—just two things. The process was designed by the Federal Reserve, it was a very conservative test. And I want to cite one example. People are focused, like the Congressional Oversight Board did, on the unemployment assumptions in the initial scenarios. Those were not the binding constraint. The loss estimates that the Fed used for its estimate were more conservative than the worst 2 year period in the Great Depression, when unemployment was in the high 20s, 30s for a period of time. Those were the ones, those were the parts of that test where the—those were the ones that were most important.

I think it was a reasonably conservative and, in some ways, the best test of that was that, in the wake of that conclusion of those results, we've seen a very, very substantial amount of equity come back into the financial system because it provided a level of clarity and disclosure about balance sheets that did not exist before. And I think that's a good test.

Now, markets don't get everything right and, you know, we're still going through a deep recession and we are at the early stage of repair and recovery. Life is uncertain and there are risks ahead. But I think it was a very carefully designed conserve test and it has helped play an important role in improving confidence in the system.

REFORMING GOVERNMENT SPONSORED ENTERPRISES

Senator TESTER. Okay. The administration, you've referenced it several times, is going to be sending out a plan for Congress on modernization and regulation for financial markets. Will there be a recommendation for Freddie Mac and Fannie Mae?

Secretary GEITHNER. The future of the GSEs, including Fannie and Freddie, will be an important, is an important challenge for us, but we are not going to—I'm violating my rule of getting ahead of the President, we're not going to recommend, in our initial proposals for reform, precisely what we think the future of those issues should be.

We are going to begin the process of consulting with Congress and a broad section of housing experts on what we think the range of options are. But we are going to defer recommendations on those things for a bit longer.

Senator TESTER. Okay. Can you give me any kind of timeframe that you're looking at?

Secretary GEITHNER. I can't yet, but we probably will next week when we lay it out. But it's just a little early, just given the scale of the stuff that we are going to get to take on. We want to do this carefully.

Senator TESTER. No problem. Thank you.

Senator DURBIN. Mr. Secretary, thank you for your time here today. We are going to allow you to leave, of course, and go about your business of saving the American economy, or lunch. Whatever is on your schedule.

ADDITIONAL COMMITTEE QUESTIONS

But we thank you very much for being here. We'll send you some questions that you might consider and, while we're changing wit-

nesses here. Mr. Shulman is going to come up here, the IRS always has the last word. We will let him take the table.

Secretary GEITHNER. Thank you. He is doing a great job and I hope you will give him the support he needs.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

DEPARTMENTAL OFFICES

Question. Secretary Geithner's testimony stated that the Treasury Department will be reducing costs by cutting the number of the Department's economic attachés from 20 to 16.

During this global economic crisis, why has the Department requested to eliminate staff tasked with communicating with our international economic partners?

Answer. The Department is working daily to address the current economic problems and ensure the quickest path to recovery. The fiscal year 2010 budget for the Departmental Offices will improve the analytical capabilities at the Department to address these challenges while also maintaining fiscal responsibility. We looked to offset some of the proposed increases in the Office of Domestic Finance and the Office of Tax Policy by identifying savings in the attaché program. The reallocation of resources will not negatively impact our long-term missions.

Treasury places great value on its international attaché presence, which helps advance Treasury priorities across a broad range of issues. Indeed, the attaché program has grown from 8 attachés in April 2007 to the 15 attachés currently in the field. Nonetheless, the five attaché posts in question are currently vacant. By extending the vacancies in the four posts in question, Treasury can help free up funding for programs focused on the domestic economic situation. We will continue to actively communicate with our international partners through our existing 15 attachés posted around the world, and we remain committed to working with our existing staff and other Executive Branch agencies to promote and support economic prosperity at home and abroad.

Question. The fiscal year 2009 omnibus provided \$6.2 million for a new Operations Center to provide the Department with a 24/7 capability to monitor the global market.

What is the current status and timetable for full functionality of the Center?

Do you agree with the previous Administration that this 24/7 capability will enhance Treasury's responsiveness to global partners and to financial crises?

Answer. The Department does support the development of an Operations Center. Construction of the Operations Center is set to start at the end of September with phase 1 (24/7 call center ops).

Phase 2, which is ongoing, is to reassess the requirements for the Treasury Markets Room in light of the evolving mission of Treasury related to financial stability and economic recovery requirements. In this context, we are also refining the interaction between the Markets Room staff, the executive communications support team, and the emergency planning team. Since the original concept of the Treasury Operations Center was developed in 2007, prior to the 2008 financial crisis and the onset of the recession, Treasury leadership has been working to leverage investments in the Operations Center to full effect. To do so, we are refining the capabilities needed in the areas of financial markets and economic policy analysis as a result of financial stability and economic recovery initiatives. Results of this assessment will be completed this fall and will inform decisions related to staffing and organizational alignment of the Markets Room.

Phase 3 will reassess the coordination and interaction between the Treasury Operations Center and the Intelligence Operations Center. Phase 3 should not require additional resources.

COMMITTEE ON FOREIGN INVESTMENT (CFIUS)

Question. The Department has seen a significant increase in its CFIUS caseload over the last several years. The fiscal year 2009 omnibus provided additional funds for CFIUS to address the growing backlog of cases.

To what extent have the additional funds allowed CFIUS to make progress in clearing out the backlog of cases?

Has the caseload dropped off significantly due to the economic crisis?

Answer. Treasury has utilized additional funding to increase critically needed staffing for CFIUS to handle the significant increase in caseload over the last several years. The number of covered transactions reviewed by CFIUS nearly tripled between 2005, when 64 notices were filed, and 2008, when 155 notices were received. Because of the statutory timelines for CFIUS reviews (30 days) and investigations (45 days), cases cannot accumulate in a backlog but must be reviewed within those required periods regardless of the transaction volume at any particular time. This is why adequate staffing to fully review each case for potential national security concerns is essential. Although there was a decline in the number of cases during the economic crisis of recent months, the number of anticipated cases in the pipeline has begun to rise. We expect that case volumes will return to levels of recent years when merger and acquisition activity picks up with economic growth.

OFFICE OF FOREIGN ASSETS CONTROL (OFAC)

Question. Building on the lifting of certain travel and trade restrictions included in the fiscal year 2009 omnibus, President Obama has committed to further opening trade and communication with Cuba.

What is the economic potential in agricultural trade between the United States and Cuba if all agriculture trade restrictions are lifted?

How does that compare to the level of agricultural trade today?

Answer. The Census Department reports that goods trade between the United States and Cuba since 2000 has been as follows:

U.S. GOODS TRADE WITH CUBA

[Millions of 2008 dollars]

	Exports	Imports
2000	8.8	0.4
2001	8.8	.....
2002	174.6	0.2
2003	303.2	0.4
2004	460.6	.....
2005	406.8	.....
2006	363.6	0.1
2007	464.3	0.3
2008	711.5	.....
1Q09	182.5	.....

Source: <http://www.census.gov/foreign-trade/balance/c2390.html#2000>.

The Trade Sanctions Reform and Export Enhancement Act of 2000 or TSRA allows sales of agricultural commodities to Cuba, while prohibiting U.S. government assistance, foreign assistance, export assistance, credits, or credit guarantees for purposes of financing such exports. TSRA also denies exporters access to U.S. private commercial financing or credit; all transactions must be conducted with cash in advance or with financing from third countries.

We do not have an estimate of the potential increase in agricultural trade with Cuba if remaining trade restrictions are lifted. A July 2007 report by the International Trade Commission estimated that the U.S. share of Cuban agricultural, fish and forest imports would increase if financing restrictions were lifted.

Question. In April of 2009, President Obama announced his intent to allow U.S. telecommunications network providers to provide phone and internet services in Cuba. However, the Cuban government would have to allow the presence of U.S. providers in Cuba for U.S. companies to enter the Cuban market, and it is unclear if or when that approval will occur.

How do you plan to pursue persuading the Cuban government to accept the operation of U.S. telecommunications companies in Cuba?

Answer. While Treasury is responsible for implementing and enforcing the Cuba Sanctions program, this question is more appropriately addressed to the Departments of State and Commerce. This would likely be part of a larger dialogue between the United States and Cuban governments over diplomatic and trade issues.

COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS (CDFI) FUND

Question. Like a lot of individuals and businesses, CDFIs are having trouble finding financing in this economy. The budget proposes to continue a provision in the Recovery Act that temporarily waives the matching fund requirement for CDFIs.

How much of the requested budget increase will fill in the gaps left open by the decrease in private financing, and how much will actually go toward expanding the reach of CDFI funds?

Answer. Treasury estimates that private sector capital contributions to CDFIs will decline by at least \$125 million in fiscal year 2010. The requested increase of \$136.6 million, or a 127 percent increase in fiscal year 2010 for the CDFI Fund, which includes \$80 million for the new Capital Magnet Fund and \$113.6 million for the CDFI Program, will provide considerable support to CDFI industry. The request also includes additional funding to support a more robust research and evaluation program and the implementation of operational improvements.

Treasury believes that 100 percent of its CDFI Program award dollars allow CDFIs to expand their reach by: (i) introducing new financial product offerings; (ii) expanding their geographic service areas; and/or (iii) increasing the number of customers served.

Question. When does the Department project that CDFIs will be able to once again secure sufficient private funding so that Congress can reinstitute the matching funds requirement?

Answer. With the onset of the financial crisis in 2008, and resulting mergers among major banks, CDFIs have experienced severe reductions in capital contributions and investments by the major depository institutions in the CDFIs over the last 2 years, as well as significant reductions in philanthropic contributions. Declining capital contributions from depository institutions, corporations, and philanthropic institutions (amounting to a decrease of at least \$125 million in private sector investments in 2010) necessitate a matching funds waiver for fiscal year 2010. Treasury is hopeful that conditions in the market will change significantly such that the matching fund requirements can be reinstated in full in fiscal year 2011. The 2010 budget requested a waiver only through 2010.

Question. Even without the matching funds requirement, CDFI grants generally only make up part of the financing package for projects such as housing units and community centers.

Considering the economic downturn, is there enough demand from high-quality CDFIs to spend the additional funds requested in fiscal year 2010?

Answer. CDFIs have seen a huge increase in loan applications since the current economic crisis began from both existing customers and customers who had been working with regulated financial institutions. Also, many CDFIs are developing neighborhood stabilization programs which entail housing and neighborhood rehabilitation, including community services. Finally, there is continuing demand for small business financing in neighborhoods that are heavily impacted by foreclosures and high vacancy rates.

Given this tremendous need for capital, Treasury believes that the \$90 million in Recovery Act funding and \$113.6 million requested in fiscal year 2010 will provide significant support to qualified CDFI Program applicants. Including the additional Recovery Act resources, the CDFI Fund will make approximately 90 awards totaling \$145 million through the CDFI Program.

CAPITAL MAGNET FUND

Question. The fiscal year 2010 budget requests an \$80 million appropriation to jump start the Capital Magnet Fund. The Capital Magnet Fund will be much like the CDFI program but will focus exclusively on the development of affordable housing. When the Capital Magnet Fund was created, Fannie Mae and Freddie Mac were required to provide revenues to the fund. However, the program has not been started because Fannie Mae and Freddie Mac are not currently in a financial position to allow them to make any contributions.

Considering the start-up time needed to administer a new program, how soon will Capital Magnet Fund grants be disbursed?

Answer. In March 2009, the CDFI Fund solicited public comments regarding the design and implementation of the Capital Magnet Fund (CMF). Over the next several months, the CDFI Fund will develop proposed regulations, the Notice of Funding Availability (NOFA) for a fiscal year 2010 funding round, a funding application, standard operating procedures for application review and awardee compliance/performance monitoring, and related automated systems. The CDFI Fund's goals are to publish the NOFA and solicit applications in the spring of 2010 and to make CMF award announcements in the summer of 2010.

Question. Please describe the major differences between the CDFI Fund and the Capital Magnet Fund.

Answer. The CMF is similar to the CDFI Program, and consistent with the CDFI Fund's core mission, in that it provides capital to organizations to support their fi-

nanancing activities, rather than providing subsidies for specific projects or units, as is the case with most other Federal housing programs (e.g., Hope VI; Low-Income Housing Tax Credit; Section Eight). However, there are several differences between the CMF and the CDFI Program:

- The CMF targets a broader pool of applicants than the CDFI Program. CMF funding is available to CDFIs and to other nonprofits, whereas CDFI Program financial assistance is only available to CDFIs.
- The size of CMF awards is expected to be much larger than CDFI Program awards. CDFI Program award requests have been capped at \$2 million per application, and award amounts have actually been lower (averaging \$1 million per applicant in the fiscal year 2008 funding round). By contrast, with an \$80 million appropriation, the CDFI Fund anticipates that it can make CMF awards in much larger amounts.
- CMF awards may only be used to attract private capital to finance the development, rehabilitation, preservation, and purchase of housing that is affordable to low-, very low, and extremely low-income households, and related economic development activities. Thus, the CMF fulfills a distinct need for flexible and innovative affordable housing financing such as: pre-development grants and loans; loan guarantees; loan loss reserves; project equity; subordinated gap financing and bridge loans. CDFI Program awards may be used for a broader range of activities including, among others: business and microenterprise lending; consumer lending; the provision of financial services; and CDFI capacity building.

Question. The Treasury Department is currently overseeing the management of Fannie Mae and Freddie Mac.

When does Treasury project that Fannie Mae and Freddie Mac will become healthy enough to begin the mandatory payments into the Capital Magnet Fund?

Answer. The Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac into conservatorship on September 7, 2008, and as conservator is responsible for overseeing the management of Fannie Mae and Freddie Mac. Consistent with its responsibilities as conservator, FHFA suspended the required Housing and Economic Recovery Act of 2008 contributions (which include the Capital Magnet Fund) by Fannie Mae and Freddie Mac in view of their losses and draws on the Treasury Department's Senior Preferred Stock Purchase facility. The ability of Fannie Mae and Freddie Mac to begin making these contributions will depend on an improvement in their overall financial condition, which is closely tied to overall conditions in the housing market.

FINANCIAL CRIMES ENFORCEMENT NETWORK (FinCEN)

Question. The fiscal year 2009 omnibus provided an \$865,000 increase for FinCEN to strengthen its global efforts to combat terrorist financing and money laundering, including for addressing a large case backlog. FinCEN's work in this area is expanding as the global financial intelligence community grows. For example, in May of 2009, the Egmont group, the international organization of Financial Intelligence Units, added nine new members, including Saudi Arabia and Sri Lanka.

Why does the budget request decline to include additional funding to continue to enhance the capacity of FinCEN to communicate and coordinate with other Financial Intelligence Units around the globe?

Answer. FinCEN continues to work with FIUs around the world to expand and enhance global financial intelligence sharing initiatives aimed at combating transnational crime threats facing U.S. financial markets. FinCEN's information exchanges and case support workload to support the growing number of FIUs continues to grow.

This is very important work and continues to be a priority for the Department, however, we are operating in a tight fiscal environment with many competing priorities. The President's budget maintains the level of staff and other resources supporting FinCEN's work with international partners; it also invests in FinCEN's IT Modernization effort, which will improve data integrity and better equip FinCEN analysts to provide accurate, complete and timely responses to requests.

Question. The President's fiscal year 2010 budget requests \$10 million to fund an upgrade to the information technology (IT) system used for financial reporting under the Bank Secrecy Act. In July 2006, FinCEN halted work on BSA Direct, the previous attempt to upgrade its IT systems. Treasury spent 2 years of planning and invested \$14.4 million in that failed system.

What lessons were learned from the previous attempt to replace FinCEN's IT systems?

Answer. An independent review of the BSA Direct program identified several key factors that played a part in its failure. The most critical of these were: unclear

project scope and requirements; inadequate program governance; and a lack of demonstrated project management experience (both Government and Contractor).

FinCEN has been diligent in resolving all of these factors, as well as taking additional steps necessary to develop a solid foundational approach to assure the success of the new BSA IT Modernization initiative. Over the last 3 years, FinCEN has developed a comprehensive IT Modernization Vision and Strategy that identifies the scope of what is required to meet customer needs; an Enterprise Transition Strategy that outlines the high level plan for how we plan to accomplish the initiative; and employed a System Development Lifecycle, based on a model that has been successful within the IRS, to execute and monitor the program. FinCEN has committed to transparency and active engagement of internal/external stakeholders, working through the Bank Secrecy Act Advisory Group (BSAAG) and establishing an active partnership with the IRS at both an operational and strategic level. Further, we are currently working to establish a project plan that will allow the IT Modernization effort to be accomplished in the most cost-effective manner.

Finally, and to address the most critical lesson learned, Treasury has emphatically addressed the issue of program governance. FinCEN has collaborated with the Department and IRS to establish proper governance and oversight for the BSA IT Modernization initiative. In 2008, the Modernization Executive Group (MEG) was created and currently serves as the highest level, integrated governing body in support of BSA information management and is tri-chaired by the Treasury Chief Information Officer, the IRS Deputy Commissioner, and the FinCEN Director. The MEG established an Executive Steering Committee, comprised of senior Departmental, IRS and FinCEN business and technical representatives, to provide oversight and guidance to the Modernization program. FinCEN also has a new bureau-wide Project Management Office and an IT-specific Modernization Management Office to ensure the day-to-day project controls are in place for successful execution of its IT Strategy. Finally, this initiative was discussed and endorsed as a Departmental priority by the Treasury Department's Executive Investment Review Board, consisting of representatives of all Treasury components for the purpose of providing executive direction and review of significant Treasury IT projects.

Question. What improvements has FinCEN made to the planning and implementation process that will avoid problems that plagued the previous failed upgrade?

Answer. FinCEN has established the organization's first enterprise business transformation and IT modernization strategy (the BSA IT Modernization Vision & Strategy), which serves as the roadmap for aligning FinCEN's IT portfolio with business objectives and processes. The bureau has also leveraged the IRS Enterprise Life Cycle to develop a System Development Life Cycle (SDLC) to ensure a robust, repeatable process is in place to manage the projects and overall program efforts required to modernize its IT environment. As part of the SDLC, the Executive Steering Committee must approve the results of each phase of the life cycle before FinCEN can move to the next phase.

Since fiscal year 2007, FinCEN has hired six seasoned managers from industry, Department of Defense, and other Federal Agencies to oversee the Technology Solutions and Services Division (TSSD), establishing an entirely new senior management team supporting IT. The Chief Information Officer and new TSSD management team have extensive experience in managing large information technology programs and IT Modernization efforts, as well as years of hands-on experience in acquisition. Over the past 2 years, TSSD has elevated all critical Contracting Officers Technical Representatives (COTRs) responsibilities to the new senior staff, while also ensuring each COTR holds the requisite Federal Acquisition Certification for COTRs (FAC-COTR). The manager responsible for overall program control is a certified Project Management Professional from the Project Management Institute and is currently undergoing the necessary steps to obtain the Federal Acquisition Certification for PM's (FAC-PM) for FinCEN's major IT investment (BSA IT Modernization).

In addition to ensuring the appropriate planning and execution processes are in place, establishing appropriate governance and oversight, and incorporating an entirely new management team, we are continuously involving both our internal and external stakeholders to ensure successful project implementation.

Question. How does FinCEN plan to involve the wide variety of stakeholders in the planning for this IT overhaul—including banks, federal law enforcement, state and local law enforcement, and other federal intelligence agencies?

Answer. FinCEN has engaged its internal stakeholders by establishing a Cross-FinCEN Integrated Product Team (IPT) made up of representatives from each FinCEN Office (Regulatory/Policy, Analytics/Liaison, International, Office of Counsel, and Management Programs). The Data Management Program and Data Management Council (DMC), which is comprised of Federal law enforcement and regu-

latory members, were established to engage FinCEN's government stakeholders. These two entities have participated in the identification and validation of BSA capabilities and requirements. In addition, FinCEN plans to engage the IPT and DMC continuously through the modernization initiatives in such System Development Life Cycle activities as user acceptance testing, training, and communications. When appropriate, FinCEN will also leverage the BSA Advisory Group, comprised of Federal representatives as well as financial institutions, for feedback pertaining to the impacts of the Modernization on their respective user communities. Finally, these processes will ensure this investment is leveraged in the most efficient manner possible by incorporating the common needs of the over 300 agencies at the Federal, State, and local levels that depend upon the system.

TREASURY INSPECTOR GENERAL

Question. The recent increase in bank failures has forced the Treasury Inspector General to defer much of its routine but important audit and investigative work in order to meet its statutory responsibility to review certain bank failures. For fiscal year 2009, Congress provided \$26.1 million for the Treasury Inspector General, a \$7.6 million increase compared to the fiscal year 2008 level, so that staff could return focus on critical audit and investigative work. However, the budget proposes an increase of just \$575,000 over the fiscal year 2009 enacted level.

Considering that analysts anticipate that a significant number of bank failures will occur in fiscal year 2010 and over the next several years, without a larger funding increase, how would the Treasury Inspector General's office be able to fully maintain its oversight work while conducting these critical bank reviews?

Answer. Based on the best information we have to date, we believe that the fiscal year 2010 budget request is sufficient for the OIG to meet its responsibilities, including material reviews. The fiscal year 2010 request allows the OIG to retain the larger workforce that was approved for fiscal year 2009, an increase of 39 FTEs, or nearly 34 percent, over the fiscal year 2008 level. We will continue to monitor OIG workload and seek additional resources if necessary.

ALCOHOL AND TOBACCO TAX AND TRADE BUREAU (TTB)

Question. The fiscal year 2010 budget proposes to charge producers, wholesalers, and retailers of beer, wine, and distilled spirits annual regulatory fees. These fees would offset the operating costs of TTB.

What impact would these new fees have on the industry?

Answer. Revenue from the proposed ongoing permanent "licensing and registration fee" starting in fiscal year 2010 would support the bureau's mission. Members of the alcohol industry (including retailers, wholesalers, breweries, wineries, distilleries, and industrial alcohol businesses) would pay fees ranging from \$300 to \$1,000, depending on the type and size of the business entity. Revenue in the first year, from annual estimated offsetting receipt collections would start out low, but grow in subsequent years to eventually offset the annual operating costs of TTB (currently around \$100 million).

Annual fees are shown in the table below. A licensing and registration fee of \$300 from over 350,000 retailers will generate an estimated 90 percent of the yearly revenue collected, while the remaining 10 percent would be collected from wholesalers and alcohol producers. TTB currently collects over \$7 billion in federal excise taxes from alcohol producers.

The licensing/registration fee would shift the burden of paying for regulation of the alcohol industry from the general public to consumers, producers, wholesalers, and retailers of alcohol beverages.

Annual Fee Requirement

The annual fees to be charged under this program are as follows:

	Amount
Retailer Dealers in Liquors and Beer	\$300
Wholesaler Dealers in Liquors and Beer	500
Alcohol Producers	1,000
Distilled Spirits Plant ¹	
Bonded Wine Cellar ¹	
Bonded Wine Warehouse ¹	
Tax paid Wine Bottling House ¹	
Every Brewer ¹	1,000
Denatured Spirits, Recovery and Tax Free Users (Industrial Alcohol)	300

	Amount
Non-beverage Domestic Drawback Claimants	500

¹ Reduced fees by substituting "\$500" for "\$1,000" if gross receipts are less than \$500.

\$500,000 for the most recent taxable year before the 1st day of the taxable period.

Certain exemptions and exceptions of the annual fee may apply to the certain business as outlined under the legislative proposal.

TROUBLED ASSET RELIEF PROGRAM (TARP)

Question. TARP places strict limitations on compensation for executives of companies receiving financial assistance from the federal government, and the Recovery Act strengthened those restrictions after weaknesses in the original TARP restrictions emerged. GAO reports that Treasury has been working to increase oversight and compliance with executive compensation restrictions, including the new provisions included in the Recovery Act.

Please provide an update on the steps Treasury is taking to institute a clear, robust process to monitor compliance with the executive compensation restrictions.

Answer. On June 15, 2009, Treasury published an Interim Final Rule ("IFR") entitled "TARP Standards for Compensation and Corporate Governance" that implements the executive compensation provisions of the Recovery Act. The IFR sets forth detailed restrictions on executive compensation applicable to TARP recipients, as well as periodic reporting and certification requirements and other procedures for monitoring compliance. The IFR also provides for the appointment of a Special Master, who has the responsibility to (i) review and approve the compensation of each of the 25 most highly compensated employees of each TARP recipient that has received exceptional assistance, (ii) review and approve the compensation plans applicable to the next 75 most highly compensated employees of each such TARP recipient, (iii) review prior compensation paid to Senior Executive Officers by TARP recipients and negotiate the return of any payments that are found to have been contrary to the public interest, and (iv) issue interpretive guidance under the rule. All TARP recipients will be required to submit detailed compensation information in order to facilitate the review process.

Question. In light of criticism that Treasury was not requiring institutions receiving TARP funds to provide detailed reports on their use of taxpayer dollars, Treasury has required that all participants in the Capital Purchase Program complete a monthly survey of lending activities. Treasury has declined to seek any further details on any TARP recipients' use of funds, with the exception of Citigroup and Bank of America, citing that such data would not be useful and would be difficult to gather.

However, the Special Inspector General for TARP sought more detailed data from over 350 TARP recipients and found that banks were, in fact, able to provide a reasonable level of detail on their use of funds. The IG reported: "... one thing is clear: Treasury's arguments that such an accounting was impractical, impossible, or a waste of time because of the inherent fungibility of money were unfounded."

Why has Treasury declined to require more detailed reporting from TARP beneficiaries?

Answer. It is important to distinguish between Treasury's capital-enhancement programs and its other programs. The Capital Purchase Program, Capital Assistance Program and institution-specific programs for AIG, Citigroup and Bank of America are designed to provide capital to cushion against losses and allow financial institutions to continue operating in the ordinary course of business, including lending to consumers and businesses. In order to serve its purpose, capital must be available for any legitimate business purpose. Although Treasury requires applicants for the Capital Assistance Program to specify how they intend to use the funds, accounting for actual use of particular dollars invested as capital is not a meaningful exercise and therefore not required. Because banks' double-entry bookkeeping systems do not trace the paths from creating liabilities (receiving capital) to investing in assets (making loans), we cannot precisely attribute the contribution of TARP capital to particular uses. The banks can, however, report trends in loans and other uses of funds, and we do require that they report such to Treasury.

On the other hand, Treasury's home ownership preservation program, small business lending initiative, auto industry programs, and the terms of Treasury's participation in the Term Asset Backed Securities Loan program impose specific limitations on the use of TARP funds, and require controls and periodic reports to insure that those limitations are respected.

Question. When Congress approved TARP, the expectation was that TARP funds would be used to purchase toxic assets—mainly, assets related to subprime and other troubled mortgages. Since then, TARP has evolved into 12 separate programs aimed at addressing different stress points in the market and at rebuilding a basic

lending capability for domestic markets. The complexity of this program has created a communications challenge. GAO reported in March 2009 that TARP is still very poorly understood by Congress and the public. GAO reports that Treasury has not yet developed an effective strategy for communicating with Congress, the public, and other stakeholders.

How can Treasury's actions support increasing confidence in the financial markets if the public does not have a basic understanding of the goals of TARP?

How can the Department better articulate and justify its strategy so that Americans and the markets can regain confidence in the economy?

What can Treasury do to educate concerned members of the public?

Answer. Treasury publishes a wealth of information about TARP investments and the activities of the Office of Financial Stability. In addition to transaction reports detailing every transaction, monthly financial reports, and tranche reports that review how each \$50 billion of TARP funds have been spent, Treasury posts on its FinancialStability.gov website all program descriptions, guidelines, frequently asked questions and answers, contracts, press releases, and a variety of other information about TARP. Treasury also maintains a separate MakingHomeAffordable.gov website that sets forth extensive information about Treasury's homeownership preservation programs.

Nevertheless, Treasury recognizes that public perceptions of TARP could benefit from improved communications. To that end, Treasury is in the process of developing and implementing an overall communications strategy that will include regular proactive briefings for Congress and the press, clearer explanations of TARP programs and OFS activities, discussions of progress being made in achieving program objectives, and expanded efforts to communicate with and educate the public about the goals and achievements of TARP.

Question. Firms that repay preferred stock purchased under the TARP program will also have the option to repurchase warrants that Treasury holds at Fair Market Value.

How is Treasury ensuring that the valuation of the warrants is accurate so that taxpayers get a return at fair market value?

Answer. Treasury will ensure that taxpayers' interest are protected by conducting a process to determine whether to accept the bank's initial determination of the fair market value of the warrants. Treasury has developed a robust set of procedures for evaluating repurchase offers, based on three categories of input: market prices, financial modeling, and outside consultants/financial agents.

Question. Contracts for implementing TARP include the primary, large contract for the asset manager, Bank of New York Mellon, as well as smaller contracts for tasks such as legal and accounting services. These contracts have for the most part been priced on a "time and materials" basis. GAO has warned that such contracts are considered "High Risk" to the taxpayer dollar. This is because, unlike fixed-price contracts, the structure of the time-and-materials contracts provides no incentive for the contractor to control for cost or labor efficiency. In a recent TARP review, GAO reported that in response to GAO's warning, Treasury has converted two time-and-materials contracts into fixed-price arrangements and is closely assessing new contracts to identify those that may effectively utilize a fixed-price contract.

What do TARP officials consider when determining the appropriate compensation structure for new contracts?

Is Treasury conducting a thorough, comprehensive review of all of its existing contracts so that more can be converted to fixed-price, lower-risk arrangements?

Answer. Treasury considers the degree to which the contract requirements can be clearly defined to permit negotiation of a reasonable price. In the legal services contracts, the requirement to create novel, unprecedented financial structures for government investment in private corporations inhibits Treasury's ability to accurately predict the level of effort that will be required. Over time, as certain transactions are repeated, our ability to reasonably predict the level of effort increases. Treasury gathers data on the number of hours required to complete transactions and uses the data to negotiate fixed prices on a per transaction basis.

Opportunities have been limited thus far to convert significant number of contracts to fixed-price due to the difficulty in estimating with a reasonable degree of accuracy the extent or duration of the required services. Due to this high degree of uncertainty, fixed-price arrangements may not be appropriate for many TARP contracts. Treasury selects appropriate contract types based on the risk to successful performance and the capacity to negotiate a fair and reasonable price for the required services. Given the still-evolving nature of TARP, and the challenge of reasonably forecasting the level of effort required to design new financial structures and execute transactions, premature conversion to fixed price contracts would place Treasury at risk of agreeing to too high a price for services rendered. Treasury is

gathering cost data from all of its time and materials and labor hour contracts to identify areas where the level of effort can be reasonably predicted, and the costs associated with those efforts, to support the future negotiation of fixed pricing for follow-on work where appropriate.

QUESTIONS SUBMITTED BY SENATOR BEN NELSON

Question. While much of the focus up until recent weeks has been placed on the auto manufacturers, the dealerships also have much at stake. Considering that the Treasury has provided auto manufacturers with a significant amount of funding and has taken on significant ownership in these companies, how much of the assistance already provided is the Treasury prepared to allow to dealerships that have lost their franchise designations and have been left with few options?

Answer. Both General Motors (GM) and Chrysler have committed to operating with transparency with regard to the dealership closings. The plans to consolidate dealer networks were developed by each company over a long period of time and were a part of their overall plans to restructure in order to achieve financial viability. Without the funds provided by the Treasury Department, GM and Chrysler's entire dealer network might have been eviscerated. Chrysler has worked to have the majority of its inventory off of the rejected dealership lots. GM has set up an appeals process for its rejected dealers and is providing them with 18 months of support to allow them to dispose of their inventory, which GM believes should be a sufficient amount of time given current inventory levels.

Question. No one disputes the importance of the domestic auto industry to our country and economy. Everyone understands we aren't only talking about the auto manufacturers. For instance in my state we are also talking about the dealerships, parts supplier, and a host of other industries that are either touched directly or indirectly by the auto industry.

However, I have great concerns about the United States government having an open-ended ownership stake in private companies because of the assistance that the federal government has provided.

What oversight is the Treasury Department prepared to take or conditions established so that domestic automakers are being good stewards of taxpayer money and can ensure the taxpayers of a return of their investment?

Answer. The government expects to protect the taxpayers' investment by managing its ownership stake in a hands-off commercial manner. Both companies now have new Boards of Directors comprised of distinguished business professionals who will help guide these companies through their ongoing restructurings. The Treasury Department will continue to monitor the taxpayer's investment under the TARP program and will seek to dispose of the ownership interest as soon as is practicable.

Question. While the federal government is a reluctant stakeholder in domestic companies, what should the American taxpayer expect when it comes to the divestment of funds they've provided to these auto companies? Are there benchmarks of solvency that are established or are planning on being established that will allow the taxpayers to be repaid of their investment in the auto companies? Will repayment of federal funds be on a continual basis?

Answer. The return will depend on the overall market, the economy, and the recovery of the auto sector. The decision to provide funds to the companies by the current Administration was based upon a determination that the companies have viable business plans. As a result, we will monitor GM and Chrysler's performance and seek the return of taxpayer funds as soon as is practicable.

Question. How can technology best be utilized to maximize transparency with regard to TARP transactions and the use of TARP funds by recipients? How can we ensure that this information is available as quickly, comprehensively and understandably as possible, for the benefit of both taxpayers and market participants?

Answer. Improving the ways in which the Office of Financial Stability (OFS) communicates its activities and shares relevant data with the public, market participants, and our oversight bodies is one of my highest priorities. Treasury has already improved its ability to share information through the development of our website, FinancialStability.gov, and I fully expect that the Internet will continue to play a central role in our efforts to operate in as transparent a fashion as possible.

We are working to add to the website's functionality, increase the resources available through the site, and develop additional features. I believe we need to expand the ability of people to interact with OFS, such as through a question and answer feature, and offer presentations of information tailored to the widest possible audience, including those people who do not regularly read the business page or follow the financial markets.

QUESTIONS SUBMITTED BY SENATOR SUSAN COLLINS

Question. An analysis of the Obama administration budget proposal by the Congressional Budget Office projects that the public debt ratio will double in 10 years, to 82 percent of GDP. This would be the highest debt level since World War II.

The CBO analysis also shows that the Obama budget will produce a deficit level averaging 5.3 percent of GDP across the 10-year budget window. Worse, the deficit level will be rising—not shrinking—toward the end of the 10-year period, reaching 5.7 percent in 2019.

Last month, you told Bloomberg Television that: “It’s very important that this Congress and this president put in place policies that will bring those deficits down to a sustainable level over the medium term,” and you added that the proper deficit target is 3 percent of GDP or smaller.

What policies do you believe should be put in place to reduce the deficit to 3 percent or less of GDP over the long term?

Answer. When we developed the fiscal year 2010 budget, we projected that the budget deficit would shrink to just above 3 percent of GDP on average during 2012–2019. The Administration’s Mid-Session Review projections show a higher deficit outlook, with deficits averaging just above 4 percent of GDP over that period. This increase is primarily driven by changes in our economic assumptions, based on new data on the severity of the recession that weren’t available when we developed the fiscal year 2010 budget.

Our first priority is to make sure that we do not choke off recovery in the near term by taking actions to reduce the deficit in the near term. As the recovery proceeds and the temporary surge in spending retreats, the deficit will fall. The process of developing the 2011 budget will include proposals for further deficit reduction to the extent that they are needed to put the nation back on a fiscally sustainable path.

Question. Thinking about our long-term debt situation for the moment, do you believe that it will be necessary to raise taxes to achieve a 3 percent deficit-to-GDP level?

Answer. We agree that it is important to keep the deficit at a sustainable level relative to GDP in the long term. The proposed fiscal year 2010 budget moved the budget deficit to about 3 percent of GDP, with a combination of some programs that raise revenue and put fiscal restraint on discretionary spending. The updated economic assumptions in the Mid-Session Review, which reflect a more severe recession than evident when the 2010 budget was developed, have raised projected deficits relative to GDP over the 10-year budget window. We would consider a wide range of approaches consistent with the President’s commitment if we see the need to further lower the deficit after the economy recovers.

Question. In his testimony before the House Budget Committee last week, Federal Reserve Chairman Bernanke made the point that the debt cannot be sustained unless “debt and interest payments . . . are stable or declining,” with “tax rates [that] are not so high as to impede economic growth.” Do you agree with the Chairman that higher taxes can impede economic growth?

Answer. Most economists agree that high tax rates can hurt economic growth and that taxes should be as low as possible while still funding the needs of the United States. But large and rising deficits that become a permanent part of the economic landscape also pose a threat to economic growth. They destroy confidence in the economy and reduce business capital spending, which will lower productivity and the standard of living.

In the longer term, all policymakers will need to balance the goal of creating a sustainable fiscal path with the goal of keeping taxes low. It does the economy no good overall to have a large deficit that saps business and consumer confidence and crowds out business spending just to keep taxes low. And likewise, it does the economy no good if needed government programs are unfunded—with attendant consequences for productivity and quality of life—just to keep taxes low.

We look forward to working with the Congress to find a sustainable balance of policies in keeping with the President’s commitments.

Question. The Treasury Department has an abysmal record for implementation of major capital IT investments. Some of these failures include FinCEN’s Bank Secrecy Act (BSA) Direct System, IRS’s web-based Electronic Fraud Detection System, and the abandoned Treasury Communication Environment.

As of last week, the Director of FinCEN was unable to explain to Appropriations Committee staff the anticipated total cost for the new BSA IT system. The FinCEN Director could also not explain how the fiscal year 2010 requested budget increase of \$11 million would be used. Given that this is a complex, multi-year effort, we would like to have more details about the fiscal year 2010 request and the long-

term project costs. Secretary Geithner, can you tell us how the \$11 million would be spent and what the long-term costs of this project will be?

Answer. The fiscal year 2010 President's budget request is part of a larger, multi-year initiative, that provides the ability to begin the integrated BSA IT Modernization Effort, including the full scope of BSA IT modernization capabilities. The fiscal year 2010 request of \$10 million will be combined with base resources of \$2.5 million to begin the project.

Specifically, the resources included in the fiscal year 2010 President's budget will be used to complete the planning, requirements, architecture and design (Lifecycle Milestone 3) activities for the following projects:

- Infrastructure
 - IT Modernization Development and Test Environment
 - Storage Area Network (SAN)
- Registered User Portal
 - User portals
 - Access Control
 - Identity Management
- E-Filing
 - E-Filing
 - E-Forms/Paper Filer Analysis
 - Shared Filing Services/Work in Progress Database
- System of Record (SOR)
 - SOR
 - Bulk Data Dissemination
 - Basic Query
 - Alerts
- Query Audit Log
- Advanced Analysis
 - Proactive Analysis
 - Analytic/Visualization Tool

In terms of long-term costs, initial estimates are for a 4-year project plan estimated at \$120 million; however, in order to create the most cost-effective solution for the taxpayer's dollar, estimates will be refined and adjusted based on the results of the fiscal year 2009 requirements and alternatives analysis.

Question. The stimulus provided the CDFI Fund with \$100 million for additional grants under its core and Native American programs and to cover associated administrative expenses. The stimulus also gave the Fund an additional \$3 billion in new markets tax credits. These new resources coupled with the Administration's fiscal year 2010 request of \$243.6 million represent a huge expansion of the Fund's programs from the fiscal year 2009 appropriation of \$107 million.

The last two financial audits issued by the Treasury Office of Inspector General cited a "significant deficiency" in the CDFI's monitoring of grant recipients to determine if those recipients had complied with their grant agreements. The auditors reported that CDFI managers continued to have difficulty communicating with each other. The auditors called this situation a "significant deficiency." I understand that the Treasury moved the chief financial officer's function out of the CDFI to the Department even though CDFI is required to have a CFO. Taken together, it appears that this office has some serious management and operational problems.

Mr. Secretary, in light of the large increase for the CDFI in the budget request, could you please comment on these issues? Specifically I'd like to know what actions the Department has taken to ensure that CDFI is making grants and awarding tax credits in a speedy but responsible manner, and how CDFI will monitor those grants to determine the money is used for their intended purposes.

Answer. Although Treasury's Office of the Inspector General (OIG) did identify concerns with respect to compliance monitoring and management communication, no material weaknesses were identified in either the fiscal year 2007 or fiscal year 2008 audits, and the CDFI Fund received a clean opinion on its fiscal year 2008 balance sheet. Since fiscal year 2007, the Department, in conjunction with the CDFI Fund, has taken action to improve the efficiency and operations of the CDFI Fund, bolstering: (1) the awardee selection process, (2) compliance monitoring, (3) management communication; and (4) other areas to better meet the CDFI Fund's mission and provide better service to stakeholders and constituents. In addition to improving operational efficiency, these steps were taken to ensure that the CDFI Fund is in alignment with Treasury directives, orders, policies, procedures, and guidelines. Treasury is confident that the CDFI Fund has the necessary systems and processes in place to ensure the full integrity of its award programs.

Awardee Selection

The CDFI Fund has an extremely rigorous application selection process that ensures awards are made in an expeditious and responsible manner. Further, the Fund has developed compliance monitoring protocols and systems to ensure that award funds are used for their intended purposes.

In fiscal year 2008, the CDFI Fund began working with an outside consultant to evaluate and streamline the CDFI Program award review and selection process. The resultant new Standard Operating Procedures streamline the application process and strengthen internal controls and accountability. Among other benefits, through these new procedures, the CDFI Fund reduced fiscal year 2009 grant selection decisions by about 60 days and reduced the time from award selection to disbursements by 120 days. In fact, the CDFI Fund anticipates disbursing substantially all of the \$98 million in Recovery Act award dollars within 60 days of award announcement.

With respect to its two largest programs, the CDFI Program and the New Markets Tax Credit (NMTC) Program, applicants are required to submit uniform application materials. Each funding application is rated and scored independently by three readers, followed by a Quality Assurance reviewer. Applications meeting previously established minimum aggregate scoring thresholds are considered eligible for an award. These eligible applicants are then reviewed again and an award determination is made.

There are several internal control safeguards that mitigate against any one person being able to exercise undue influence over the selection of awardees, including:

- Conflict of interest policies preclude a reader from reviewing an application of an applicant for which the reader has a previous, current, or potential relationship, financial or otherwise.
- Readers score applications independently and in remote locations. They do not discuss their reviews with other team members. Reviewers cannot communicate directly with one another regarding their applications without first making contact with the Quality Assurance reviewer.
- Review Forms provide instructions to readers with respect to how each element is to be scored, thus helping to limit reader variance.
- The relative weight ascribed to each scoring element is computer-generated and unalterable by the reader, thereby limiting the degree to which a reader can change the outcome of an overall application score.
- Each Review Form is reviewed by a Quality Assurance reviewer to ensure that (i) the reader followed the scoring guidelines and (ii) the scores are appropriate, given the reader's ratings and narrative.
- If a reader review results in a scoring anomaly, the application is re-scored by a fourth reviewer and the anomalous score will likely be disregarded.
- If the Selecting Official varies significantly from the recommendation of the review manager, a third person (the Reviewing Official) is engaged to make a final determination.

Compliance Monitoring

The significant deficiencies noted by the Treasury Inspector General for the compliance area focused on a lack of consistency in following established written policies and procedures to determine awardee compliance. The auditor's recommendation to address these significant deficiencies was to increase staff resources dedicated to compliance and monitoring. The CDFI Fund implemented these recommendations, hiring a compliance manager and additional staff, as well as providing additional training to the compliance staff. It also updated compliance monitoring policies and procedures related to awardee financial statements.

With respect to awardee compliance and performance monitoring, the CDFI Fund has developed automated on-line data collection tools, known as the Community Investment Impact System (CIIS) and the CDFI Compliance Monitoring System (CCMS), through which CDFI Program and NMTC Program awardees report institution- and transaction-level information and reports to the CDFI Fund annually, along with their audited financial statements. The CDFI Fund uses these reports to verify compliance with award agreements, and they are a valuable source of data for program evaluation and dissemination of information about the CDFI industry.

In addition to reviewing the annual financial statements and reports from all of its awardees, the CDFI Fund engages in "desk audits" and site visits each year to a small percentage of awardees. Desk audits are ordered when a potential issue of non-compliance is discovered through standard review of annual reports, and generally require the awardee to provide additional clarifying information and/or supporting documentation. Site visits may be conducted in response to a particular incidence of non-compliance, and are scheduled for a random sample of awardees.

Management Communication

The Department takes very seriously the Inspector General's findings with respect to the need to improve management communication within the Fund, and has instituted a number of initiatives to address this concern. In addition to weekly meetings with the management team, the CDFI Director has established quarterly all-hands meetings and monthly brown-bag lunches with the staff to ensure employees have an opportunity to raise concerns, receive recognition for exemplary work and discuss cross-cutting issues impacting all of the Fund's programs.

Recently, the Fund established the position of Chief Operating Officer to bring together core management and administration functions.

In addition, the Fund has encouraged program managers to conduct offsite planning retreats with their staff. Three out of seven managers have already held these sessions; the remaining four will be convened within the next 60 days.

Steps and Actions Taken to Improve CDFI Fund Operations

Numerous other steps and actions taken to improve CDFI Fund operations include:

- Comprehensive, third-party assessment of the CDFI Fund's financial management functions and capabilities, which resulted in the appointment of Treasury's Assistant Secretary for Management/Chief Financial Officer as the CDFI Fund's Chief Financial Officer. Through this action, the CDFI Fund benefits from standardized financial management and internal control processes, enhanced cost effectiveness, and improved risk management.
- Creation of new programmatic Standard Operating Procedures by Booz Allen Hamilton, which were implemented in late fiscal year 2008 and continue to be refined.
- Comprehensive skills assessment (conducted by Booz Allen Hamilton) of CDFI Fund program staff, to identify the resources necessary to carry out the new Standard Operating Procedures.
- Assessment of the CDFI Fund's human resource functions and the transfer of services to the Office of Human Resources, which allows CDFI Fund employees and managers to have consistent with the rest of the Department's employees, in addition to the establishment and implementation of human capital policies and procedures approved by the Office of Human Resources.
- Procurement of a minority-owned vendor to provide support in updating position descriptions of all employees, training in writing employee specific performance plans using Treasury's new performance management system, and tailoring Individual Development Plans for all CDFI Fund employees to reflect the new Standard Operating Procedures and defined roles and responsibilities.
- Implementation of "best practice" recruitment tools so as to recruit a diverse talent pool, including the use of multiple recruiting mechanisms and hiring authorities.
- Development and implementation of a new strategic plan for fiscal year 2009 with line staff involvement.
- Establishment of a performance-based awards program to encourage continued improvements of the CDFI Fund's programs and operations through motivation and reward of employees.
- Creation of a strong collaborative working relationship with union representatives to identify bargaining unit employee needs and concerns.

Question. Mr. Secretary, during your recent trip to China, I was troubled by the response you were given by some in China when you attempted to assure the Chinese that their investments in U.S. Treasuries are "very safe." As the Washington Post put it in an editorial on Friday, the fact that the Chinese question the trustworthiness of bonds backed by the full faith and credit of the United States should serve as a "wake up call" for all Americans.

China is currently the largest purchaser of U.S. Treasuries and many high level Chinese officials are worried about the safety of their assets and have begun to push for alternatives to the dollar as a reserve currency. Such a move would be disastrous for the United States and world economy. How do you intend to avoid such a move by the U.S. Government's largest creditor?

Answer. We are confident that the dollar will remain the major currency of use in international transactions and thus a major reserve currency. The attractiveness of the dollar to foreign investors is the unparalleled breadth, depth, and liquidity of U.S. financial markets and the confidence that foreign investors have in the long-term prospects of the American economy and American economic policy.

As Secretary of the Treasury, I am committed to ensuring that the U.S. economy and U.S. financial markets are vibrant, robust, and open to foreign investors. In ad-

dition to ensuring a growing economy, the President is committed to reducing the medium- and long-term federal budget deficit and securing fiscal sustainability.

Question. Treasury has pumped at least \$70 billion into the failing multinational corporation, AIG. This insurance company nearly failed not because of its insurance business but because it had engaged in hundreds of Credit Default Swaps transaction which it could not cover when counterparties all came calling for payment at the same time. AIG used much of the TARP funds to pay these counterparties, not only Goldman Sachs, but many foreign banks, including Deutsche Bank and Societe Generale. The Special Inspector General has raised questions about whether Treasury could have used its contribution to AIG as leverage to monitor these payments and force these counterparties to accept a “haircut” on their payments. After all, without Treasury’s injection of funds, AIG would have failed and they likely would have received nothing at all. Do you believe Treasury missed an opportunity to save taxpayer dollars?

Answer. When evaluating the costs to the taxpayer of Treasury’s support of AIG, the benefits also should be taken into account.

The disorderly failure of AIG would have caused direct damage to the system as a whole and would likely have lowered overall risk appetite throughout the system due to the heightened uncertainty that such an event would have generated. As with all of our TARP programs, we have two goals—preserving the stability of the financial system as a whole and making sure that the taxpayers are protected and appropriately rewarded for the risk they are taking. The mitigation of systemic risk generates significant, but difficult to quantify, benefits for taxpayers.

Moreover, Treasury makes every effort to protect the taxpayer. Treasury works with AIG to maximize the chances that AIG can repay the government for its very significant financial support. In this way, the success of AIG as a business and the success of AIG’s restructuring are very much in the taxpayer’s medium- to long-term interest.

Treasury understands that, as a steward of taxpayer dollars, we must work hard to ensure that the financial support offered to AIG is not wasted or abused.

Treasury’s ability to impose “haircuts” on AIG’s derivatives counterparties is extremely limited due to the nature of derivatives contracts. Most derivatives trades are governed by standardized contracts (ISDAs) and many have so-called credit support annexes or CSAs, which govern the posting of collateral. The purpose of a CSA is to mitigate counterparty credit risk, thereby enabling the parties to focus on pricing and trading the underlying risk factors instead of worrying about whether their counterparty will be able to pay, should the trade swing in their favor. This feature facilitates liquidity, price discovery, risk transfer, and the functioning of markets generally.

Under a CSA, the failure to meet a collateral posting obligation in full generally constitutes an event of default and results effectively in the immediate termination of the underlying trades. Most of the governing contracts also contain a provision that a default on any other such contract (e.g., with another counterparty) constitutes a default on that particular one, which gives rise to so-called “cross-default risk.” Put simply, if AIG were to unilaterally “haircut” one of its counterparties by posting less than the contractually obligated amount, that would constitute an event of default, trigger cross defaults, and result in mass trade terminations. In the fall of 2008, AIG had almost 50,000 derivative trades in a wide variety of asset classes with over 1,000 counterparties. Defaulting then would have destabilized an already fragile market.

This is why the Administration has proposed a special resolution regime to give the government the tools necessary for an orderly resolution of complex non-bank firms, in which creditors and counterparties may share in the losses.

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

TOXIC ASSETS

Question. The Administration seems to be still treating the symptoms but not the cause of the financial credit crisis. Throwing billions of taxpayer dollars at the banks without cleansing the toxic assets is simply throwing money down a rat hole. And it appears that your plan to address the toxic assets—the so-called PPIP program—may never get off the ground given FDIC Chairman Sheila Bair’s recent announcement to postpone the program. Many people, including myself, are highly skeptical of the PPIP program, in the first place, since it is voluntary for the banks to participate. Without forcing the banks to clean up their balance sheets and ex-

pected losses mounting in the commercial and residential real estate markets and credit card markets, we are simply postponing their day of reckoning.

In your testimony, you seem to indicate that Treasury intends to still move forward with PPIP.

How do you intend to go forward with the PPIP program given the government's inability to attract bank participation since it is voluntary? Is there a Plan B?

Answer. Treasury is committed to the Legacy Securities PPIP, and we have been finalizing the details over the past several months. The Legacy Securities PPIP will address the market for commercial mortgage-backed securities (MBS) and non-agency residential MBS. Treasury announced in early July that it had selected nine pre-qualified fund managers that will receive up to \$30 billion in investments from Treasury. As of October 5, 2009, Treasury announced three additional closings of Public-Private Investment Funds (PPIFs) established under the Legacy Securities Public-Private Investment Program (PPIP), bringing the total number of initial closings completed to five. As of October 5, total Treasury commitments to these five PPIFs amounts to \$16.67 billion, of which \$9.20 billion has been closed on. Including private capital, total PPIP closings to date amount to \$12.27 billion. Fund managers have established relationships with small, minority- and women-owned businesses. Following an initial closing, each PPIF will have the opportunity for two more closings over the following 6 months to receive matching Treasury equity and debt financing, with a total Treasury equity and debt investment in all PPIFs equal to \$30 billion (\$40 billion including private investor capital).

Financial market conditions have improved since the early part of this year, and many financial institutions have raised substantial amounts of capital as a buffer against weaker than expected economic conditions. However, these legacy assets are still highly illiquid despite significant increases in the prices of many of these securities. The difficulty of obtaining private financing on reasonable terms to purchase these assets has limited the ability of investors to reduce liquidity discounts in legacy assets. The lack of clarity about the value of these legacy assets has also made it difficult for some financial institutions to raise new private capital and has continued to clog balance sheets.

One of the PPIP's primary objectives is to facilitate price discovery and reduce excessive liquidity discounts that have been embedded in legacy asset prices. As capital is freed up, U.S. financial institutions should engage in new credit formation. Furthermore, enhanced clarity regarding the value of legacy assets should increase investor confidence and enhance the ability of financial institutions to raise new capital from private investors. Finally, an inherent link exists between the new issue securitization market and the secondary market performance of legacy assets. As spreads compress in the legacy asset market, new securitization issuance should come to market at reasonable borrowing costs. The new issue securitization market is an absolutely critical component of lending in the economy.

REGULATORY REFORM

Question. Clearly, our financial regulatory system must be addressed since it played a role in the current credit crisis. One of the core issues is how to address "too big to fail" companies. Some argue that "too big to fail" is now "too big to exist."

Is anti-trust reform being considered as part of the Administration's regulatory reform proposal? How are you proposing to align the incentives properly to prevent future irresponsible behavior by financial institutions and future taxpayer-funded bailouts?

Answer. While effective enforcement of anti-trust laws is an important part of protecting consumers and competition in the financial sector, we have not proposed anti-trust reform as part of our regulatory reform proposals. We do not believe that the risks we propose to address are directly related to competition issues that can be addressed through an anti-trust framework.

In the past 2 years, we learned that the system was not resilient enough to bear the failure of a large, interconnected firm or contain the damage from such a failure on the broader economy. The problem was that such firms had not been required to maintain sufficient capital and liquidity cushions and were not supervised on a consolidated basis. In other words, they were not required to internalize the risks they presented to the financial system. Our plan fixes that.

Under our plan, firms that could present risks to the stability of the financial system if they failed will be subject to much higher standards so that the risk of failure will be lower. Moreover, our special resolution regime for nonbank financial firms gives the government an effective tool for an orderly resolution, in which creditors and counterparties may share in the losses rather than a bailout. In addition, we will reduce incentives for risk taking by reforming and raising capital standards for

financial firms and working to address misalignment of incentives in specific markets, like the securitization markets, through such steps as requiring originators or sponsors to maintain an economic interest in the performance of a securitization.

Finally, we have proposed steps to align the compensation of executives with the long-term interests of shareholders so that they do not have incentives for excessive risk-taking—both through regulation and supervision of financial firms and through corporate governance reform, such as “say on pay” legislation and legislation requiring independent compensation committees on corporate boards of directors.

SOCIAL AND ECONOMIC MISSIONS

Question. There is growing concern about asking weakened financial institutions to carry out the government’s economic and social policies. While I understand the pressure to have bailed-out banks more engaged in efforts such as foreclosure mitigation, the danger is more financial losses that will be covered with more taxpayer funds. Further, this leads to more government involvement in dictating private business practices.

What is the Administration’s exit strategy when it comes to those financial institutions—such as Fannie and Freddie, Citi—who are being required by the government to carry out various social policy programs? How will you avoid the negative consequences of forcing these entities to fulfill the inherent conflicting goals of serving shareholders and meeting the needs of the public good?

Answer. Given the important role that Fannie Mae and Freddie Mac play in the mortgage market, their participation in efforts to reduce preventable foreclosures is vital to speeding the housing recovery. The future of Fannie Mae and Freddie Mac will require careful consideration of the appropriate role of the Federal government in the mortgage market. The Administration has committed to undertaking a wide-ranging initiative to develop recommendations by early next year on the future of Fannie Mae and Freddie Mac. There are a number of options for the reform of the GSEs, including: (i) returning them to their previous status as GSEs with the paired interests of maximizing returns for private shareholders and pursuing public policy home ownership goals; (ii) gradually winding-down their operations and liquidating of their assets; (iii) incorporating the GSEs’ functions into a federal agency; (iv) introducing a public utility model, in which the government regulates the GSEs’ profit margin, sets guarantee fees, and provides explicit backing for GSE commitments; (v) instituting a conversion to providing insurance for covered bonds; or (vi) dissolving Fannie Mae and Freddie Mac into many smaller companies.

The 2008 Housing and Economic Recovery Act (HERA) reformed and strengthened the regulation of Fannie Mae and Freddie Mac by establishing a Federal Housing Finance Agency (FHFA) as a new independent regulator. In addition to the establishment of FHFA, HERA also provided FHFA with enhanced authority to develop regulations regarding the safety, soundness, and the mission activities of Fannie Mae and Freddie Mac.

STRESS TESTS

Question. Many experts question the reliability of the stress tests that were conducted on the large banks. Some believe that the results are too optimistic because the tests were too lenient and banks bargained with the government to reduce their capital needs. Further, to meet the capital levels required by the stress test results, it was reported that banks are relying on preferred-stock conversions for 22 percent of their fundraising. One financial expert stated that “Conversions from preferred to common don’t do anything; you can just ignore them.”

Do you stand by these tests? If so, can you assure the American taxpayer that they will not be asked to fund additional rounds of bailouts for these large banks? Will you conduct more stress tests? If so, under what circumstances would you conduct more stress tests?

Answer. The Supervisory Capital Assessment Process (SCAP) or “stress test” was a carefully designed, stringent test. The test was designed to account for the highly uncertain financial and economic conditions by identifying the extent to which our largest banks are currently vulnerable to a weaker than expected economy in the future.

Supervisors applied a historically high set of loss estimates on securities and loans, as well as a conservative view towards potential earnings that could act as a buffer against those losses. For instance, the 2-year, loan-loss rate assumed under the “more adverse” scenario exceeds the observed 2-year loss rates for U.S. commercial banks from 1920 to present.

Since the stress test results were announced more than \$80 billion of total private capital has been raised by the 19 participating institutions. This additional private

capital reduces the likelihood that the U.S. government will need to inject additional public capital into the banking system. Treasury must balance the desire to exit its investments in private sector entities as quickly as is practicable with the need to ensure that such a withdrawal does not put the progress that the Obama Administration has made in restoring financial stability at risk. To that end, Treasury will continue to provide support where it is necessary to sustain confidence in the financial system and to support critical channels of credit to households and businesses. The SCAP focused not only on the amount of capital but also on the composition of capital held by the largest banks. That is, SCAP focused on the proportion of capital that is common equity. The SCAP's emphasis on common equity reflects the fact that common equity is the first element of the capital structure to absorb losses, offering protection to more senior parts of the capital structure and lowering the risk of insolvency. All else equal, more common equity gives a bank greater permanent loss absorption capacity and a greater ability to conserve resources. Therefore, while we were particularly pleased with the record amounts of new common equity that was raised following the SCAP, we also believe that exchanges of preferred stock for common stock have enhanced the ability of some of our largest institutions to withstand a weaker than expected economic scenario.

Currently there are no plans to conduct another stress test of the largest banks.

PROTECTIONISM

Question. Despite history's lessons on how protectionism contributed to the Great Depression, there continues to be active efforts from some in Congress to push trade protectionism, which will clearly endanger our economic recovery. There are reports that the "Buy American" provision in the stimulus has slowed down some projects and has contributed to some job losses. Now, there is an effort on the House side that is pushing protectionism further on climate change legislation by tying federal aid to companies that only develop and produce plug-in cars in the United States.

What is the Administration's official policy on protectionism and free trade? What is the Administration doing to prevent the growth of protectionism? Will it work to stop these types of protectionist measures?

Answer. President Obama has clearly stated that trade is a key engine for U.S. economic growth and job creation. The President has also emphasized the importance of avoiding protectionism in responding to the financial and economic crisis.

As part of the commitment made by G-20 Leaders to avoid protectionist trade measures, the World Trade Organization (WTO) was tasked to monitor and report on trade and trade policy-related reactions to the financial and economic crisis, a process in which the United States actively participates. While continued vigilance is important, thus far the process appears to be working—in large part due to the presence of WTO rules and the effect of very visible individual and collective monitoring. Moreover, where protectionist measures are identified, the United States will engage our trading partners in both bilateral and multilateral settings. Enforcement of WTO rules is a top priority.

With respect to the American Recovery and Reinvestment Act of 2009, we appreciate that Congress responded to the President's call to avoid protectionism in responding to the financial crisis and included a provision in the Recovery Act that ensures that the "buy American" requirement is applied in accordance with U.S. international agreements on government procurement. Public comments have been solicited on an interim Federal procurement rule and interim OMB guidance implementing the "buy American" requirement in the Recovery Act. After a thorough review of the public comments, a final rule and final OMB guidance will be prepared with the aim of ensuring that the law is implemented effectively and consistently with the objective of promoting economic recovery and job creation.

As the Congress prepares legislation, the Administration will continue to review proposed bills with a view to ensuring that they avoid protectionism and that they are fully consistent with our international trade obligations.

REPAYMENT OF TARP FUNDS

Question. The Administration has begun some banks to repay funds from the Troubled Asset Relief Program (TARP).

For these cases—especially those who are still considered "too big to fail"—how can you assure the taxpayer that they will not return to the government trough for more bailout funds? Can you definitely say that they will not be back for more taxpayer-funded bailouts?

Answer. The government's Supervisory Capital Assessment Program (SCAP), the so-called "stress test", estimated the capital needs for major banks under an adverse economic scenario. In particular, the SCAP estimated losses that those banks are

likely to incur through 2010 and the appropriate level of loan loss reserves at the end of that period. The estimated losses and the required level of reserves took into account the potential for significant additional declines in housing prices and further increases in mortgage defaults resulting from, among other things, interest rate resets. We believe that the SCAP captured the likely capital needs of the major banks under an economic scenario that is more adverse than what we, and private forecasters, expect. Since the stress test results were announced, many major banks have raised a substantial amount of new private capital. This additional private capital reduces the likelihood that the U.S. government will need to inject additional public capital into the banking system. Treasury must balance the desire to exit its investments in private sector entities as quickly as is practicable with the need to ensure that such a withdrawal does not put the progress that the Obama Administration has made in restoring financial stability at risk. To that end, Treasury will continue to provide support where it is necessary to sustain confidence in the financial system and to support critical channels of credit to households and businesses.

AUTO RESCUE

Question. The Administration has orchestrated and forced the car companies into bankruptcy but seems to be reluctant to force failed large financial institutions like Citi into restructuring.

Why are you treating failed financial institutions differently from GM and Chrysler? If Citi is not forced into a FDIC-like restructuring, how can you assure the taxpayer that they will not return for additional bailouts?

Answer. In acting to help financial institutions such as Citigroup and the automotive industry, the overarching goals of the Administration have been the same: promote the liquidity and stability of the financial system and protect the taxpayer. The actions taken have depended on the particular circumstances facing the different institutions.

The Administration took action to help the automotive industry in order to prevent a significant disruption to the industry, as conditions in the industry posed a risk of creating significant disruptions to financial market stability and negative effects on the real economy of the United States. One of the conditions on which the Administration initially provided loans to these companies was that they develop viability plans. As a result of development and consideration of these plans, it became clear that the best way to achieve viability was for GM and Chrysler to substantially restructure their businesses. Due to a variety of factors, Chapter 11 bankruptcy proved to be the most effective means of accomplishing this important goal.

Last fall, the Administration and Congress believed quick, forceful action was necessary to stabilize the financial system and certain financial firms. With Congressional authorization, these actions were taken to meet the specific needs of the time and to address the distinct difficulties faced by financial firms as a result of the crisis. The Treasury initially provided support to Citigroup on the same terms as over 650 institutions received funding pursuant to the Capital Purchase Program. The Treasury subsequently determined that additional assistance was needed to Citigroup pursuant to the Targeted Investment Program. This program is used when an institution is sufficiently important to the nation's financial and economic system that a loss of confidence in the firm's financial position could potentially cause major disruptions to credit markets or payments and settlement systems, destabilize asset prices, significantly increase uncertainty, or lead to similar losses of confidence or financial market stability that could materially weaken overall economic performance. This assistance is provided on terms that are more restrictive than those under the CPP program. These include more stringent restrictions related to executive compensation, dividend payments, share repurchases, corporate expenses, internal controls and other matters.

Citigroup was also one of the banks examined as part of the government's Supervisory Capital Assessment Program (SCAP), the so-called "stress test", which estimated the capital needs for major banks under an adverse economic scenario. In particular, the SCAP estimated losses that those banks are likely to incur through 2010 and the appropriate level of loan loss reserves at the end of that period. The estimated losses and the required level of reserves took into account the potential for significant additional declines in housing prices and further increases in mortgage defaults resulting from, among other things, interest rate resets. We believe that the SCAP captured the likely capital needs of the major banks, including Citigroup, under an economic scenario that is more adverse than what we, and private forecasters, expect. Since the stress test results were announced, many major banks have raised a substantial amount of new private capital. This additional private capital reduces the likelihood that the U.S. government will need to inject addi-

tional public capital into the banking system. Treasury must balance the desire to exit its investments in private sector entities as quickly as is practicable with the need to ensure that such a withdrawal does not put the progress that the Obama Administration has made in restoring financial stability at risk. To that end, Treasury will continue to provide support where it is necessary to sustain confidence in the financial system and to support critical channels of credit to households and businesses.

INTERNAL REVENUE SERVICE

STATEMENT OF DOUGLAS H. SHULMAN, COMMISSIONER

Senator DURBIN. I am pleased to welcome Douglas Shulman, now well-immersed in his second year of a 5 year term as the 47th Commissioner of the Internal Revenue Service. Thank you for your service and your pledge to lead the IRS from good to great.

Each year, IRS employees make hundreds of millions of contacts with American taxpayers and businesses and represent the face of our Government to more U.S. citizens than any other agency. With approximately 93,000 employees, the IRS is effectively the accounts receivable department of the United States.

In fiscal year 2008, the IRS collected \$2.7 trillion, 96 percent of total Federal receipts. Simply stated, the more revenue the IRS collects, the more revenue Congress has available to deal with some of the challenges facing our Nation and the more revenue we have available to ease the tax burden on those citizens we believe to be deserving of that. Conversely, the less revenue, the less revenue Congress has for tax cuts or for worthy expenditures.

The President's proposed budget of \$12.126 billion for the IRS is an overall increase of 5.2 percent above the fiscal year 2009 enacted level, which supports 95,081 full-time equivalents (FTEs) and an additional 2,376 above the current fiscal year 2009 base.

Mr. Commissioner, thank you for your patience. Thank you for joining us. Senator Collins and others may have some questions along with mine after you've given your presentation. The floor is yours.

OPENING STATEMENT OF COMMISSIONER SHULMAN

Commissioner SHULMAN. Thank you Chairman Durbin and Ranking Member Collins. I appreciate the opportunity to testify about the IRS's fiscal year 2010 budget.

Over the past year, I think the agency has shown that it can improve performance and be agile and respond to changing situations. I often say that we need to excel at both service and enforcement. It's not an either/or proposition. And I believe this budget will allow us to make continuous improvements in both our service and our enforcement, as well as in technology and the workforce.

As the Secretary mentioned, the President's budget requests \$332 million in additional enforcement initiatives. This set includes a robust set of international enforcement initiatives that the President, the Secretary, and I unveiled on May 4.

Increased resources for IRS compliance initiatives have direct measurable results through a return on investment, and this \$332 million will yield about \$2 billion a year once it becomes fully operational in 2012.

In addition, we've asked for money so we can continue to improve our service, including face-to-face, telephone, web-based, and self-

service service models. I believe it is incredibly important and fundamental to keeping honest taxpayers in the system that we have world-class service. And it's a key part of bringing in the \$2.5 trillion it takes to run the Government every year.

And as you mentioned, Mr. Chairman, we are the face of the American Government to more people than any other agency. In this regard, I also want to point out to the subcommittee that I plan to deliver recommendations to the President and the Treasury Secretary by the end of this year on how we, the IRS, can better leverage the tax return preparer community to increase compliance and ensure high ethical standards of conduct for paid preparers.

Over 80 percent of the American people use either tax software or a paid preparer to prepare their return each year. This has been a transformational shift in the way taxes are prepared. And because paying taxes is one of the largest financial transactions that individual Americans have each year, we need to make sure that the professionals who serve them are ethical and that they ensure the right amount of taxes are paid.

I'm also pleased to report that we've moved, for the second year in a row, to enact stimulus legislation. This year we implemented major provisions of the American Recovery and Reinvestment Act, getting money into the hands of individuals, as well as small businesses.

Let me turn briefly to our ongoing effort to modernize our core taxpayer account database. We have consistently delivered on commitments over the last several years. This year I have adopted a much more focused strategy, which will allow the IRS to complete the taxpayer database conversion on an accelerated timeframe. We're doing this by gradually shifting course from simultaneously developing the database and the associated applications, to a more streamlined focus on completing the modernized database. This is going to be key to our future success, to future on-line services, and to new compliance and enforcement systems.

This budget also reflects our long-term commitment to efficiency savings and productivity. With e-filing going up, I'll just note we've consolidated processing centers into 5 sites instead of 10, and we project 5 year savings to be over \$100 million.

And finally, let me just point out three important legislative changes in the President's budget. There are many on which we worked and I support them all. Three very important ones are: one, the robust set of international legislative proposals which will be essential to us curbing offshore tax abuse; two, the proposal to require tax preparers that have a certain volume of tax filings to file electronically; and three, the proposal that we eliminate the 20 percent downpayment for a taxpayer who comes in trying to enter a offer in compromise with us. Those are often taxpayers in financial distress and right now they have to put 20 percent down. There's been some decrease in the program and we want to get the program back up and so we are recommending getting rid of that 20 percent payment.

PREPARED STATEMENT

Mr. Chairman and Ranking Member Collins, thank you again for the opportunity to testify. I am happy to answer any questions.

[The statement follows:]

PREPARED STATEMENT OF DOUGLAS H. SHULMAN

INTRODUCTION

Chairman Durbin, Ranking Member Collins, and Members of the Subcommittee, thank you for the opportunity to appear today to discuss the President's fiscal year 2010 budget request for the Internal Revenue Service. The President's budget represents a strategic and wise investment in the Nation's tax system and will help the IRS stay on a path of continuous improvement in such critical areas as service, enforcement, technology, and human capital.

Through its service delivery, the IRS is often the face of government to the American people. The IRS is the only agency that interacts with every business, every taxpaying individual, and every non-profit organization each year. We have that rare opportunity to influence how people think about their government.

In terms of service, I believe that taxpayers want to come to the IRS, get their questions answered and issues resolved quickly, and be on their way. It sounds simple, but in a time of increasing complexity of the tax law, and challenging economic circumstances, achieving this goal will require discipline, focus, and resources. Our service operations must be designed with the taxpayer experience as the ultimate measure of our success.

We also need a vigorous and effective enforcement program. In today's tough economic environment, it is more important than ever that every citizen feels confident that individuals and corporations are paying the taxes they owe.

The American people who play by the rules every day expect the IRS to pursue those taxpayers who do not pay their taxes, and we are vigorously enforcing the tax law. We are focusing on current enforcement initiatives, such as in the international arena, while seeking to evolve and innovate. We can also hone our enforcement techniques by adding new tools, such as more information reporting, soft notices, and self-correction.

Of course, all of our efforts depend upon the people of the IRS. We must ensure that we have talented and capable leaders and employees for the foreseeable future at the IRS, and that they have the tools and resources they need to succeed.

We also need to continue moving our technology to the next level. The tax system, America's taxpayers, and the approximately \$2.5 trillion of revenue depend on it.

Finally, as I announced last week, I plan to make recommendations by the end of the year to Secretary Geithner and the President on how to better leverage the tax preparer community to increase taxpayer compliance and ensure uniform and high ethical standards of conduct for preparers. Today, over 80 percent of taxpayers use either a tax return preparer or third-party software to complete their returns. This is nothing less than a transformational shift in tax administration. The first part of the review I plan to undertake will involve fact finding and receiving input from a large and diverse constituent community. Paying taxes is one of the largest financial transactions individual Americans have each year, and we need to make sure that professionals who serve them are ethical and ensure the right amount of tax is paid.

A FIRM FOUNDATION UPON WHICH TO BUILD

The IRS has a firm foundation upon which to build. Let me briefly highlight some key trends that demonstrate both across-the-board performance improvements and the IRS' ability to be agile and respond quickly to changing situations.

Service

As of May 9th, for the 2009 filing season, the IRS has received 133.2 million total individual returns and has issued 102.3 million refunds, for a total of \$278.5 billion. A record 91.6 million tax returns were electronically filed this year—a major milestone for the IRS and testament to our commitment to a robust electronic tax administration program. So far this filing season, the e-filing rate is almost 70 percent for individuals, as compared to 61 percent for the same time period last year.

This year, there was also a surge in e-file from home computers. More than 31 million people prepared their own e-file return, representing more than a 19 percent increase from the previous year. And there were almost 200 million visits to IRS.gov, comparable to last year.

Taxpayers could also find on the IRS Web site the latest information about the American Recovery and Reinvestment Act (ARRA), including details on extending health insurance for people who lost their jobs and tax breaks for first-time home-

buyers. In addition, the IRS has developed “What If” scenarios and the possible tax implications for people who may be facing financially difficult times.

American Recovery and Reinvestment Act

The IRS is proud of the role it has played, and will continue to play in helping to implement, provide guidance, and publicize many of the provisions of the ARRA that will assist both individuals and businesses in economic distress and is getting the Nation back on the road to economic recovery.

For example, a mere 4 days after President Barack Obama signed ARRA into law, the Treasury Department and the IRS swung into action in record time, developing new withholding tables to ensure money would get into American’s pockets through the Make Work Pay Credit.

In March, the IRS announced that businesses with deductions exceeding their income in 2008 can use a new net operating loss tax provision to get an expedited refund of taxes paid in prior years. This provision could throw a lifeline to struggling businesses, providing them with a quick infusion of cash. We are also making it as easy as possible for businesses large and small to take advantage of these benefits.

We have shifted resources to deal with the expected growth of bankruptcies and business workouts. Moreover, we worked with the Treasury Department on a number of regulations that clarified rules to unclog the credit markets.

On the individual front, we have taken a broad approach. Through a series of massive, nation-wide outreach efforts, such as “Super Saturday,” we wanted to make sure that even more taxpayers are aware of every credit, deduction, and exclusion for which they qualify, including several new benefits this year.

Our message to taxpayers was that we are going the extra mile to help those in economic distress. We want to get them their refunds as quickly as possible. And if they think they can’t pay, we ask them to come in and talk about it. There are steps we can take to help.

The bottom line is that we need to be flexible yet principled and to empower our employees to use their judgment when dealing with these taxpayers in areas such as missed payments and postponing collection actions.

This year there are also a variety of new benefits and tax credits the IRS is administering that can also help energize the economy and generate much needed jobs. We are working with the media and other stakeholder groups to get out the message about their availability.

Enforcement

In fiscal year 2008, both the levels of individual returns examined and coverage rates rose substantially. We conducted nearly 1.4 million examinations of individual tax returns in fiscal year 2008, an 8 percent increase over fiscal year 2006. This reflects a steady and sustained growth over the past 3 years. Similarly, the audit coverage rate has risen from 0.58 percent in fiscal year 2001 to 1.01 percent in fiscal year 2008.

While the growth in examinations of individual returns is visible in all income categories, it is most apparent in examinations of individuals with incomes over \$200,000. Audits of these individuals increased from 105,549 in fiscal year 2007 to 130,751 during fiscal year 2008, an increase of 24 percent. Their coverage rate has risen from 2.68 percent in fiscal year 2007 to 2.94 percent in fiscal year 2008.

In the business arena, audit coverage rates for small corporation returns (assets under \$10 million) increased slightly over fiscal year 2007 by .03 percent. Of note, coverage rates for three classes of large corporations with assets between \$50 million and \$250 million and higher all increased. Coverage rates for partnership returns stayed even as compared to fiscal year 2007, while Subchapter S returns reflected a small .05 percent drop due largely to the increase in number of S-corporations. The coverage rate for tax-exempt organizations increased slightly.

IRS Criminal Investigation has also been vigorously attacking egregious tax avoidance, money laundering, and other financial crimes that have a corrosive effect on our tax system. For example, overall number of individuals charged in an information or indictment rose from 2,323 in fiscal year 2007 to 2,547 in fiscal year 2008.

Over the same period of time, prosecution recommendations for employment tax evasion more than doubled. The incarceration rate in these investigations was 81 percent and the average sentence was 29 months.

In fiscal year 2008, IRS-developed cases related to foreign and offshore issues also resulted in 61 criminal convictions, and the average term for those going to jail was 32 months. For the first 4 months of fiscal year 2009, there were 20 convictions, and the average sentence was 84 months.

IRS Workforce

In late fiscal year 2008, the IRS established the Workforce of Tomorrow task force to address recruitment and retention issues so that the IRS has the necessary leadership and workforce in place to address future challenges.

The IRS considers employee engagement fundamental to the overall success of the organization and believes that employee engagement is an ongoing process. The IRS conducts an annual survey to assess the level of engagement of employees. Overall satisfaction showed steady improvement from a score of 3.48 in 2002 to a score of 3.79 in 2008, on a scale of 1 to 5, with 5 being the most satisfied.

IRS job satisfaction is higher than most other Federal agencies, according to the Office of Personnel Management's Federal Human Capital Survey.

THE ADMINISTRATION'S FISCAL YEAR 2010 BUDGET REQUEST FUNDS KEY PRIORITIES

Total resources to support IRS activities for fiscal year 2010 are \$12,440,801,000. This amount includes \$12,126,000,000 from direct appropriations, an estimated \$147,101,000 from reimbursable programs, and an estimated \$167,700,000 from user fees. The direct appropriation is a \$603,402,000 increase, or a 5.2 percent increase over the fiscal year 2009 enacted level of \$11,522,598,000. This amount excludes funding to implement the ARRA.

The IRS continues to achieve efficiency savings in its operations. Because of the increase in e-filing, the IRS has effectively revised base operations and continues to implement savings resulting from the consolidation of an additional two of the paper processing sites. This consolidation has already resulted in significant savings and will continue to do so.

The IRS Strategic Plan 2009–2013 guides program and budget decisions and supports the Department of the Treasury Strategic Plan. The IRS Strategic Plan builds on past successes while being innovative and adapting to new situations, such as the increasing complexity of tax laws, changing business models, expanding use of electronic data and related security risks, accelerating growth in international tax activities, and growing human capital challenges. I am a firm believer that organizations must always be evolving, changing, and improving and the strategic plan reflects that philosophy.

The IRS Strategic Plan has two overarching goals: (1) improve service to make voluntary compliance easier; and (2) enforce the law to ensure everyone meets their obligation to pay taxes. The IRS must excel at both service and enforcement to meet its mission; it is not an either-or proposition.

To improve service and make voluntary compliance easier, the fiscal year 2010 President's budget request for IRS provides the necessary funding to implement the following key strategic priorities.

Enforcement Program

The fiscal year 2010 President's budget request includes program increases of \$332.2 million for investments in strong compliance programs, including a robust portfolio of international enforcement initiatives that the President and Treasury Secretary Geithner and I unveiled on May 4, 2009.

The international initiatives include reforming business tax deferral rules so that—with the exception of research and experimentation expenses that have significant spillover benefits to the United States—companies cannot receive deductions on their U.S. tax returns supporting their offshore investments until they pay U.S. taxes on their offshore profits. The Administration also seeks to prevent abuse of the foreign tax credit.

In addition, getting tough on overseas tax havens is an integral part of the Administration's plan. It would reform the so-called "check-the-box" rules to require certain foreign subsidiaries to be considered as separate corporations for U.S. tax purposes. It would also crack down on the abuse of tax havens by wealthy Americans. For example, the Administration proposes withholding taxes from U.S. customer accounts at foreign institutions doing business with the United States but which don't share information with the IRS through the "Qualified Intermediary" program. To further combat abuse, the Administration proposes extending the statute of limitations for international tax enforcement to 6 years.

The Administration's full budget describes additional international tax reform proposals. Other legislative proposals to improve compliance and strengthen tax administration can be found later in this testimony. A key focus of our strategy is to shift enforcement resources so we can expand programs targeted at non-compliance among large corporations, U.S. business with international operations, high net-worth individuals, flow-through entities and partnerships.

Increased resources for the IRS compliance programs yield direct measurable results through high return-on-investment activities. The new enforcement personnel funded in the fiscal year 2010 President's budget are expected to generate \$2.0 billion in additional annual enforcement revenue once the new hires reach full potential in fiscal year 2012. This estimate does not account for the deterrent effect of IRS enforcement programs, which are conservatively estimated to be at least three times larger than the direct revenue impact.

The tax law is complex, and even sophisticated taxpayers make honest mistakes on their tax returns. Accordingly, helping taxpayers understand their obligations under the tax law is critical to improving compliance. To this end, the IRS remains committed to a balanced program of assisting taxpayers in both understanding the tax law and paying the proper amount of tax.

Taxpayer Service Program

The fiscal year 2010 President's budget request continues improvements to both the quality and efficiency of taxpayer service, using a variety of person-to-person, telephone, and web-based and self-serve methods to help taxpayers understand their tax obligations and pay what they owe. The IRS taxpayer service program is funded in the Taxpayer Services and Operations Support appropriations. It should be noted that service investments and strategy are guided by the Taxpayer Assistance Blueprint—a 5-year plan that outlines the steps the IRS should take to improve taxpayer service and the IRS strategic plan.

Providing quality taxpayer service is fundamental to keeping honest taxpayers in the tax system and compliant. It also helps them avoid making unintentional errors before returns are filed, which, in turn, reduces the need for follow-up correspondence from the IRS.

The IRS provides year-round assistance to millions of taxpayers, including outreach and education programs, issuance of tax forms and publications, rulings and regulations, toll-free call centers, the IRS.gov web site, Taxpayer Assistance Centers (TACs), Volunteer Income Tax Assistance (VITA) sites, and Tax Counseling for the Elderly (TCE) sites.

For example, in the Small Business arena alone, in fiscal year 2008, the IRS participated in over 2,600 meetings, symposiums, and seminars attended by over 162,000 small business owners and tax professionals. The IRS also holds national and local Small Business Forums which provide an open avenue of communication between IRS and trade and industry groups. We held 135 Small Business Forums and facilitated 410 Small Business Tax Workshops in fiscal year 2008.

American Recovery and Reinvestment Act

As noted in the introduction, the IRS is now implementing a number of ARRA tax provisions, including individual tax credits, such as the Make Work Pay credit; energy credits for certain appliances, education credits, and child credits; tax incentives for business; bond incentives; and a tax credit to provide discounted health benefits to certain workers who have lost their jobs. The IRS will be able to continue to implement and administer these critical tax programs within the levels contained in this budget request.

EXPLANATION OF BUDGET ACTIVITIES

Enforcement

The fiscal year 2010 President's budget request is \$5,504,000,000 in direct appropriations and an estimated \$60,797,000 from reimbursable programs, plus an estimated \$7,800,000 from user fees¹, for a total operating level of \$5,572,597,000. The direct appropriations level is an increase of 7.6 percent from the fiscal year 2009 enacted level and includes \$600,000,000 to support tax enforcement activities funded by an allocation adjustment. This appropriation funds the following budget activities.

Investigations (\$637,694,000 from direct appropriations and an estimated \$51,553,000 from reimbursable programs).—This budget activity funds the criminal investigations programs that explore potential criminal violations of the internal revenue tax laws, enforce criminal statutes relating to these violations, and recommend prosecution as warranted. These programs identify and document the movement of both legal and illegal sources of income to identify and document cases of suspected intent to defraud. It also includes investigation and prosecution of tax and money laundering violations associated with narcotics organizations.

¹Note that user fees are available to supplement appropriations contingent on demand for user fee services and receipt of fees. These amounts are subject to change.

Exam and Collections (\$4,706,350,000 from direct appropriations, an estimated \$8,783,000 from reimbursable programs, and an estimated \$7,800,000 from user fees).—This budget activity funds programs that enforce the tax laws and compliance through examination and collection programs that ensure proper payment and tax reporting. The budget activity also supports appeals and litigation activities associated with exam and collection.

Regulatory (\$159,956,000 from direct appropriations and an estimated \$461,000 from reimbursable programs).—This budget activity funds the development and printing of published IRS guidance materials; interpretation of tax laws; advice on general legal servicing, ruling and agreements; enforcement of regulatory rules, laws, and approved business practices; and supporting taxpayers in the areas of pre-filing agreements, determination letters, and advance pricing agreements.

The Office of Professional Responsibility is funded within this budget activity and is responsible for identifying, communicating, and enforcing the Treasury Circular 230 standards of competence, integrity, and conduct of professionals representing taxpayers before the IRS.

Taxpayer Services

The fiscal year 2010 President's budget request is \$2,269,830,000 in direct appropriations, an estimated \$39,000,000 from reimbursable programs, and an estimated \$127,000,000 from user fees, for a total operating level of \$2,435,830,000. The direct appropriations level is a reduction of 1.0 percent from the fiscal year 2009 enacted level, though it does not represent a program reduction due to non-recurrent activities and savings. This appropriation funds the following budget activities.

Pre-Filing Taxpayer Assistance and Education (\$676,063,000 from direct appropriations, an estimated \$819,000 from reimbursable programs, and an estimated \$18,700,000 from user fees).—This budget activity funds services to assist with tax return preparation, including tax law interpretation, publication production, and advocate services. In addition, funding for these programs continues to emphasize taxpayer education, outreach, increased volunteer support time and locations, and enhancing pre-filing taxpayer support through electronic media.

Filing and Account Services (\$1,593,767,000 from direct appropriations, an estimated \$38,181,000 from reimbursable programs, and an estimated \$108,300,000 from user fees).—This budget activity funds programs that provide filing and account services to taxpayers, process paper and electronically submitted tax returns, issue refunds, and maintain taxpayer accounts. The IRS continues to make progress in decreasing paper returns and increasing the use of electronic filing and payment methods. As previously noted, a record 90 million tax returns were filed electronically this year.

Operations Support

The fiscal year 2010 President's budget request is \$4,082,984,000 in direct appropriations, an estimated \$47,304,000 from reimbursable programs, and an estimated \$32,900,000 from user fees, for a total operating level of \$4,163,188,000. The direct appropriation level is an increase of 5.6 percent from the fiscal year 2009 enacted level and includes \$290,000,000 of support funding for enhanced enforcement activities. This appropriation funds the following budget activities.

Infrastructure (\$900,852,000 from direct appropriations, an estimated \$155,000 from reimbursable programs, and an estimated \$16,100,000 from user fees).—This budget activity funds administrative services related to space and housing, rent and space alterations, building services, maintenance, guard services, and non-Automated Data Processing (ADP) equipment.

Shared Services and Support (\$1,296,629,000 from direct appropriations and an estimated \$32,228,000 from reimbursable programs).—This budget activity funds policy management, IRS-wide support for research, strategic planning, communications and liaison, finance, human resources, and equal employment opportunity and diversity services and programs. It also funds printing and postage, business systems planning, security, corporate training, legal services, procurement, and specific employee benefits programs.

Information Services (\$1,885,503,000 from direct appropriations, an estimated \$14,921,000 from reimbursable programs, and an estimated \$16,800,000 from user fees).—This budget activity funds staffing, equipment, and related costs to manage, maintain, and operate the information systems critical to the support of tax administration programs. The IRS business programs rely on these systems to process tax and information returns, account for tax revenues collected, send notices for taxes owed, issue refunds, assist in the selection of tax returns for audit, and provide telecommunications services for all business activities including the public's toll-free telephone access to tax information.

Business Systems Modernization (BSM)

The fiscal year 2010 President's budget request is \$253,674,000 in direct appropriations. This amount is an increase of 10.3 percent from the fiscal year 2009 enacted level. This appropriation funds the planning and capital asset acquisition of information technology (IT) to continued modernization of the core taxpayer account database.

This effort is a critical underpinning of the next generation of IRS service and enforcement initiatives. The integration strategy includes a particular focus on enhanced information technology security practices and robust accounting and financial management controls. This activity also funds the ongoing development of the Modernized e-File platform for filing tax returns electronically. The account also funds BSM labor (salaries and expense dollars) and related contract costs.

Health Insurance Tax Credit Administration (HITCA)

The fiscal year 2010 President's budget request is \$15,512,000 in direct appropriations. This amount is an increase of 0.7 percent from the fiscal year 2009 enacted level. This appropriation funds costs to administer a refundable tax credit for health insurance to qualified individuals, which was enacted as part of the Trade Adjustment Assistance Reform Act of 2002 (Public Law 107-210).

FISCAL YEAR 2010 BUDGET ADJUSTMENTS

The IRS funding increase for fiscal year 2010 is \$603,402,000, which includes \$256,329,000 for maintaining current levels; a net decrease of \$115,794,000 from efficiencies, savings and reinvestments; and a program increase of \$462,867,000 to strengthen enforcement, address IT security needs and deploy information technology systems. These investments also fund increased front-line enforcement efforts. By fiscal year 2012, these investments are projected to increase annual enforcement revenue by \$2.0 billion.

The budget request supports these activities by proposing:

- \$332,160,000 to target the tax gap by addressing underreporting of tax associated with complex international activities; expanding enforcement efforts on noncompliance among business and high-income taxpayers; and minimizing revenue loss by increasing document matching efforts;
- \$108,100,000 to address critical IT operational and security infrastructure needs; and
- \$22,607,000 to accelerate efforts to modernize the core taxpayer account database.

Fiscal Year 2009 Enacted Level

The fiscal year 2009 enacted level for the IRS is \$11,522,598,000, supporting an estimated 94,209 FTE.

Maintaining Current Levels

Adjustments Necessary To Maintain Current Levels +\$260,061,000/0 FTE.—Funds are requested for: fiscal year 2010 cost of the January 2009 pay increase of \$80,054,000, the proposed January 2010 pay raise of \$148,894,000, and non-labor related items such as contracts, travel, supplies, equipment, and GSA rent adjustments of \$31,113,000.

Government-wide Reduction for Productivity Improvements -\$13,732,000/0 FTE.—The IRS continues to focus on improving the efficiency of its operations through a disciplined process of productivity improvement. Additional efficiency savings are outlined in the next section.

GAO Audit Reimbursement Pursuant to Public Law 110-323 +\$10,000,000/0 FTE.—This estimated adjustment will provide funds to reimburse the Government Accountability Office (GAO) for the audit of the IRS annual financial statements. The IRS must pay this cost pursuant to Public Law 110-323. In prior years, GAO conducted the financial statement audit for which it did not receive reimbursement.

Efficiency Savings

Increase e-File Savings -\$8,360,000/-182 FTE.—This decrease is a result of savings from increased electronic filing (e-File), which is projected to lead to 4.6 million fewer returns filed on paper (2.9 million individual and 1.7 million business) in fiscal year 2010. This is projected to result in a savings of 182 FTE in submission processing.

Non-Recur Savings -\$27,074,000/0 FTE.—This decrease is the net reduction of one-time costs associated with the IRS fiscal year 2009 enforcement initiatives.

Non-Recur Stimulus Savings –\$67,900,000/ –1,322 FTE.—One-time resources were provided in fiscal year 2009 to meet the requirements of the Economic Stimulus Act of 2008 (Public Law 110–185).

Non-Recur Fiscal Year 2009 Reduction Adjustment/Correspondence Inventory –\$13,439,000/0 FTE.—One-time resources were provided in fiscal year 2009 to handle the increased adjustment/correspondence workload that resulted from diverting staff from paper correspondence to telephone service to meet the requirements of the Economic Stimulus Act of 2008 (Public Law 110–185).

Non-Recur Pension Plan Form Processing –\$1,352,000/0 FTE.—This decrease results from the funding of the one-time cost in fiscal year 2009 to test the IRS ERISA (Employee Retirement Income Security Act of 1974) Residual Solution (IERS) system. This system will process the electronic Form 5500, Annual Return/Report of Employee Benefit Plan from the new Department of Labor ERISA Filing Acceptance system and the paper Form 5500EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement.

Reinvestment

Submission Processing Consolidation (Andover) +\$2,331,000/0 FTE.—Increased use of electronic filing options has led to consolidation of the individual return processing sites. Increased e-File savings will be reinvested to fund one-time severance pay costs for the ramp-down of the Andover submissions processing site. As the Andover consolidation approaches, the IRS will continue to assist employees in finding employment either in or outside the IRS.

Program Increases

Reduce the Tax Gap Attributable to International Activities +\$128,064,000/ +784 FTE.—The IRS plans a multi-year investment, beginning in fiscal year 2010, to deal more effectively with increasing international tax activities of individual and business taxpayers.

This multi-year investment will improve the identification and coverage of international issues and increase issue specialization to address increasingly complex international transactions by both business and individual taxpayers. It will bring an unprecedented increase in international resources with the specialized skills to identify and examine international non-compliance.

The resources will improve the use of data we receive from non-U.S. entities and foreign governments, provide the needed legal resources, and address aggressive profit allocation activities of multinational entities doing business in the United States.

This effort will also focus on increasing reporting compliance of domestic taxpayers with offshore activity. The additional resources will allow the IRS to implement a stronger presence in offshore activities that will be able to uncover the use of offshore credit cards, disguised corporate ownership, brokering activities, and non-U.S. financial institutions providing banking services to U.S. and non-U.S. persons. This initiative will also fund the anticipated growth of collection activities resulting from increases in small and large business examination assessments, foreign investment transactions, and withholding compliance for nonresident aliens.

Finally, this initiative will allow the IRS to increase its overseas presence by adding attachés in key countries to continue our efforts to aggressively combat abusive foreign tax schemes and other tax evasion schemes. These resources are also a key component in supporting the Department of Treasury's objective of "Pre-empted and neutralized threats to the international financial system and enhanced U.S. national security."

This multi-pronged approach will aggressively target the many areas of offshore tax abuse with the goal of identifying more of these abuses and curbing this activity.

Improve Reporting Compliance of Small Business and High Income Taxpayers +\$94,215,000/ +755 FTE.—This initiative will improve reporting compliance by increasing examinations of business and high-income returns and exams involving flow-through entities by 47,400; audits targeting employment, excise, and estate and gift taxes by 6,350; and investigations of business non-filers by 183,000. This request will generate \$567.2 million in additional enforcement revenue once new hires reach full potential in fiscal year 2012.

Expand Document Matching for Business Taxpayers +\$26,237,000/ +300 FTE.—This initiative will increase the coverage of the document matching program to reduce the number of business taxpayers who misreport their income. This request will generate \$386.5 million in additional revenue once new hires reach full potential in fiscal year 2012.

Address Nonfiling/Underpayment and Collection Coverage +\$83,644,000/ +491 FTE.—With expanded enforcement efforts in recent years, the IRS must invest in

improving its collection operations to ensure appropriate overall balance and coverage. This initiative will generate \$359.4 million in additional revenue once new hires reach full potential in fiscal year 2012. In addition, this initiative will fund the rent, furniture, telecommunication, and IT costs to build two new Automated Collection System (ACS) sites.

Address IT Security and Material Weakness +\$90,000,000 / +36 FTE.—Improving IT security is necessary to ensure the integrity of the tax system and maintain taxpayer confidence. This initiative will allow the IRS to enhance enterprise security risk management; harden software applications and network infrastructure security; improve security compliance monitoring and reporting; and provide an enterprise solution to deploy end-to-end audit log collection.

Implement Return Review Program (RRP) +\$18,100,000 / +10 FTE.—In fiscal year 2008, the Electronic Fraud Detection (EFDS) System stopped \$1.4 billion in erroneous refunds. This initiative will complete modernization of the IRS fraudulent refund detection systems. It will deliver an integrated and unified RRP system that will enhance IRS capabilities to detect, resolve, and prevent criminal and civil tax refund and abuse.

Business System Modernization (BSM) +\$22,607,000 / 0 FTE.—This initiative will provide funding for the continued modernization of the core taxpayer account database. This effort is a critical underpinning of the next generation of IRS service and enforcement initiatives. The integration strategy includes a particular focus on enhanced information technology security practices and robust accounting and financial management controls.

Legislative Proposals

The fiscal year 2010 President's budget includes a number of legislative proposals intended to improve tax compliance with minimum taxpayer burden. These proposals will specifically target the tax gap and generate nearly \$10 billion over the next 10 years. The Obama Administration proposes to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties.

Modify Electronic Filing Requirements.—Electronic filing benefits taxpayers and promotes effective tax administration because it decreases processing errors, expedites processing and payment of refunds, and allows the IRS to efficiently maintain up-to-date records. This proposal would require electronic filing by tax return preparers (initially defined by a set threshold amount).

Expand Information Reporting.—Compliance with the tax laws is highest when payments are subject to information reporting to the IRS. Specific information reporting proposals would:

- Require information reporting on payments to corporations;
- Require a certified taxpayer identification number (TIN) from contractors;
- Require increased information reporting on certain government payments; and
- Increase information return penalties.

Improve Compliance by Businesses.—Improving compliance by businesses of all sizes is as important. Specific proposals to improve compliance by businesses would:

- Require electronic filing by certain large organizations; and
- Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes.

Strengthen Tax Administration.—The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:

- Expand IRS access to information in the National Directory of New Hires for tax administration purposes;
- Make repeated willful failure to file a tax return a felony;
- Facilitate tax compliance with local jurisdictions;
- Extend statutes of limitations where State tax adjustments affect Federal tax liability;
- Improve the investigative disclosure statute;
- Repeal the requirement of a partial payment with an application for an offer-in-compromise; and
- Allow assessment of criminal restitution as tax.

Expand Penalties.—Penalties play an important role in discouraging intentional non-compliance. Specific proposals to expand penalties would:

- Impose a penalty on failure to comply with electronic filing requirements; and
- Clarify that the bad check penalty applies to electronic checks and other forms of payment.

IMPROVE TAX ADMINISTRATION AND OTHER MISCELLANEOUS PROPOSALS

The Administration has put forward additional proposals relating to IRS administrative reforms. These proposals would:

- Require information reporting on expense payments relating to rental property;
- Improve the foreign trust reporting penalty;
- Apply the Federal Payment Levy Program to contractors before providing Collection Due Process; and
- Clarify that vendor levy on “goods and services” would not exclude “property.”

CONCLUSION

Mr. Chairman, thank you again for this opportunity to testify on the President’s fiscal year 2010 budget for the Internal Revenue Service. We urge its passage. It provides the IRS with the much needed resources to provide taxpayers with high quality customer service, and bolster IRS enforcement in critical areas, such as unlawful offshore tax evasion. It also makes wise investments for the next generation of technology and the IRS workforce.

I also urge this Subcommittee to support the enactment of the legislative proposals included in the budget to improve compliance. Collectively, they will generate more \$10 billion over the next 10 years if enacted.

I look forward to working with you and the Subcommittee on this important budget request and I will be happy to respond to any questions.

REGULATION OF PREPARERS

Senator DURBIN. Thank you, Mr. Shulman. Three States that I know of here, the staff has found, Oregon, California, and Alabama, already regulate tax preparers. Can you find, in their State regulation, evidence that the tax preparers in those States are doing a better job?

Commissioner SHULMAN. Some of this regulation is pretty recent and it is a relatively small subset. The Government Accountability Office (GAO) has actually done some studies of State regulation and what is effective. It kind of is across the board, everything from registration, to registration and licensing, to actual continuing education.

What I announced last week is that I’m going to have a wide-open discussion about this. We’re going to invite the industry in; we’re going to invite taxpayers in; we’re going to invite consumer advocates in. I would love to work with the subcommittee on this and look and say, “what’s the most effective way for us to work with that community to make sure there’s good compliance?” And that could include service and education. It clearly will include ramped up enforcement of the bad preparers, and then regulation is on the table. And we will closely look at those States——

MISTAKES ON RETURNS

Senator DURBIN. Are there some parts of the 1040 or schedules and such where you most often find mistakes being made?

Commissioner SHULMAN. The most common mistakes occur where there’s complexity. Refundable credits are one place there’s quite a bit of mistakes, including the earned income tax credit. Another common mistake is math error, like not putting your Social Security number right. One of the reasons we encourage electronic filing is it often catches math errors. You can’t submit it until the form is complete.

Senator DURBIN. Years ago, my bookkeeper in Springfield, Illinois passed away and I said, listen, I’m a lawyer. I took a tax course, I’ll do my own tax return. I think every Member of Con-

gress should be required to do their own tax return. I think we'd have tax simplification in a hurry in this country.

And, as you might guess, the IRS sent back my tax return and said, you did a math error here, Mr. Durbin, which was a humbling experience and disqualifies me from service in the President's Cabinet. But, having said that, it was an eye opener.

REFUND ANTICIPATION LOANS

May I ask you about refund anticipation loans (RAL). I don't know if you are familiar with these. I have co-sponsored legislation to require companies operating as refund loan facilitators that offer loans to register with the Federal Government. The National Consumer Law Center found that the effective annualized rate, interest rate, for a refund anticipation loan can range from 50 percent to 500 percent.

Is the IRS doing anything at this point to address concerns about refund anticipation loans?

Commissioner SHULMAN. A couple of things. One of the most important things we do is continue to get our technology in order, so that we can get refunds out quickly to people, so they can get money in their pockets without having to take a RAL. Now, if you electronically file and choose a direct deposit, you may get your refund back in under 10 days. Anecdotally, it may come back in even fewer days.

If we can finish our modernized taxpayer database, every taxpayer will have the opportunity to get a refund back quicker. So, one key to addressing RALs is to get rid of the need. I personally think that it's incredibly unfortunate that people's financials are in a state, many times often not their own doing, that they need to take a high-interest loan and that they can't wait the 10 days to get this refund. As we look at the whole preparer issue, refund anticipation loans are clearly an associated service that some preparers provide, and we will take a look at this.

The focus is on preparer conduct, but clearly all the related industries will be part of the preparer review.

PERFORMANCE ON TOLL-FREE PHONE LINES

Senator DURBIN. What about answering the phone at the IRS? You reduced your performance goal from providing telephone assistance from 82 percent last year to 77 percent this year. I wonder why you did that. And what steps are you taking to improve the IRS's telephone performance for next year?

Commissioner SHULMAN. Phones have been stressed after sending checks out to all the American people last year, this year doing the Recovery Act, and the truing up the checks. Just to give you a sense, in 2007, we had 48 million calls between January and May. In 2008, we actually had 64 million and in 2009 we had 74 million.

And so one thing we have done as a result is redone our call routing to make it quicker for people to get in the right queue and answer important questions quickly for people, filing-dependent questions.

Second is, we're trying to push more taxpayers to the Web. So, for instance, one of the reasons for the decline this year is about

5 million people called and said, "what is my adjusted gross income?" Next year, we will have a Web service to get your adjusted gross income.

And then third, we've actually added an estimated wait time. So, if you call and it says it is going to be 15 minutes before we get to you, you can hang up and call back when it's not as busy.

So, we're doing a lot of refinements. I think the reality is lots of Government services are competing for money. We are trying to figure out the right number for level of service. I think the 77 percent doesn't mean 23 percent are unhappy. Only 7 percent got a busy signal or disconnected; it's a much smaller number. And so we're trying to get better at the Web and figure out the right level of service.

PHISHING AND DATA PROTECTION

Senator DURBIN. Two weeks ago, I got the best e-mail that I could possibly imagine. It was from the IRS! And they told me that I had a refund coming. I was elated, \$600. It's terrific. I'll think of something to do with that.

Of course you know as I know, right off the bat, there's something wrong with this. Can you tell me what it is?

Commissioner SHULMAN. We don't send e-mails to people soliciting things.

Senator DURBIN. And so there are lots of scams like that out there. This person wanted me to send back some information so they could send me a refund check, nominally in the name of the IRS.

Do you go after these folks? Do you try to initiate prosecution?

Commissioner SHULMAN. We're very troubled. We would like to get the message out that you are not going to get an unsolicited phone call or an e-mail from the IRS telling you that you have some special deal with the IRS. So people should just delete that. We shut down about 2,000 sites this year. It is called phishing, sending out e-mail pretending like they are the IRS. We work with law enforcement authorities when we see these. We have hot lines. We have lots of people reporting to us. Two thousand Internet sites have been shut down just this filing season. We are very aggressive about it.

Some of these are originating from overseas and it's hard for—

Senator DURBIN. My friends from Nigeria have an ongoing correspondence with me.

Thank you. Senator Collins.

Senator COLLINS. Thank you, Mr. Chairman. I just want to associate myself with the chairman's last question to express concern about the need for more enforcement and education to deal with these scams. They are pervasive. I've talked with the Federal Trade Commission (FTC), but the IRS can certainly play an important role as well in alerting consumers.

Consumers are particularly confused because, 2 years ago, they received rebate checks from the Federal Government. So when they get an e-mail message supposedly from the IRS saying that "your stimulus check is now available," they equate it to the rebate checks.

So I just want to second Senator Durbin's concern in that area. I think we need to do more both to educate consumers and go after the people who are perpetrating these scams, which is difficult to do in an Internet world.

TAX GAP

Let me switch to some other issues. The IRS Oversight Board, in its statement to this subcommittee, identified two serious weaknesses of our tax administration system. The first is the \$290 billion tax gap, and the second is what the Board referred to as the archaic nature of IRS information systems. And I am well aware of that second issue because year after year after year, the GAO puts the IRS informations systems on its high risk list.

I'd like to start with the tax gap issue and ask you what you think should be done to address the tax gap, in addition to better enforcement.

Commissioner SHULMAN. I would say that tax gap numbers are imperfect and a lot of them are extrapolated numbers from 1980 data. The only way to really get good tax gap numbers is to do random audits. We like to do our audits in a more focused, risk-based way, so random audits would be a burden on people.

With that said, we take the tax gap very seriously. I think there are three important things that can be done with tax gap. One is simplification. As long as the Tax Code is this complex, people are going to make mistakes and people are going to have opportunities to use the complexity of the system for evasion.

Second is information reporting. All our statistics show that if we get a W-2 from an employer and tax is withheld at the source, we have 99 percent compliance. When people operate a cash business, and there's no information reported to us and it is all voluntary, the compliance rate is much lower. The Congress passed a couple of very important information reporting provisions last year, such as credit card reporting for small businesses, as well as basis reporting. They will be helpful.

The President's budget this year has very important information reporting proposals, especially in the international context. So we would get more information about across-border wire transfers, and that is going to be important.

And so, the first step is simplification and the second step is information reporting. We also are taking a look at this whole issue of how to leverage preparers to be part of the system. If you think about the image of someone sitting down with the 1040 form and a pencil, the chairman notwithstanding, not that many people do that anymore. People are using a third party, someone as an intermediate. And those people need to be part of the solution to getting people to pay the right amount of taxes. Because when they don't, it is actually a huge disservice to the American people. You know, if you end up paying penalties and interest and having trouble with the IRS, your preparer hasn't done you any favors. So, I think that the whole issue of leveraging preparers is going to be part of our tax gap strategy.

REGULATION OF PREPARERS

Senator COLLINS. Let me follow-up on the issue of so-called bad preparers. Do you make referrals to State licensing boards when you identify a “bad preparer” who is a CPA? Because they’re the ones who have the ability to impose sanctions.

Commissioner SHULMAN. Under Circular 230, we have the ability to impose sanctions on anyone who represents a person before the IRS. We can also give preparer penalties and then we coordinate with States. And so we do all of the above. It is such a transformational shift, with so many people using a third party, standing between them and the IRS, that we need to have this overall strategy. It includes the punitive aspect of enforcement, but also includes making sure that we are getting the right education, the right services, to preparers so that they can serve the American people well.

INTERNATIONAL ACTIVITY AND THE TAX GAP

Senator COLLINS. Does the IRS have an estimate of the tax gap attributable to international activities? The reason I ask this is you mentioned in your opening statement offshore tax abuses, and it seems that that is the focus of your fiscal year 2010 enforcement initiative.

Commissioner SHULMAN. The short answer is no. We don’t have a good international tax gap estimate. The reason for that is, to get good estimates that we are willing to put out, we actually need to do random audits. To do them internationally, we have to coordinate with other law enforcement agencies. By its nature, the reason that people evade paying taxes by going overseas is its hard for the U.S. Government to get to them.

There are some wildly high estimates that are based on total deposits and how many are overseas, and assuming that no one is paying taxes on them. There are some numbers that get bandied about as part of the debate.

For me, when I think about tax gap and I think about enforcement, I think not only about the dollars that we’re going to bring in directly, but also about the deterrent effect and how we project fairness to all American people.

And so the international issues that are very important to me are to go get the money that is being hidden offshore. And I also think ordinary Americans need to know that, if they are wealthy and have a lot of assets and are playing the international capital markets, they are not going to get a free pass while firemen and teachers are paying their fair share of taxes. And so it’s a long way of saying it’s part of collecting the \$2.5 trillion you need to run the Government. This is a matter of fundamental fairness and the deterrent effect, and people need to know that the U.S. Government is on the job.

BUSINESS SYSTEMS MODERNIZATION

Senator DURBIN. I would like to ask one follow-up question here. It is on CADE, customer account data engine. I am kind of noticing, I worked with Senator Collins on this issue after 9/11 on technology in the Federal Government. And I have to tell you, after fol-

lowing it for years, it has been a source of frustration of how many bad starts we've had different with different agencies, trying to bring modern technology. Maybe the private sector has the same problem, but it seems to be endemic at the Federal Government.

Your CADE system, a core component of BSM, Business Systems Modernization, was intended to replace the original master file. It has now cost over \$400 million since work began almost 5 years ago. But it has only delivered only about 15 percent of the full capability intended. The fiscal year 2010 budget request proposes a 10 percent increase for BSM, or about \$24 million of the \$229.9 million enacted last year.

Has the IRS taken actions to address GAO's recommendations to fully revisit the division's strategy for Business System Modernization, including developing long-term plans for completing the program?

Commissioner SHULMAN. I'm aware of the GAO report that came out yesterday and have a couple of thoughts.

The first thing I did when I came in is I talked to lots of stakeholders. I talked to GAO and our auditor and I said, you know, tell me about CADE. To put it into perspective, CADE is a \$50 million or so project each year within a \$1.5 billion technology portfolio. And so while it's important because it is our core database, it is not everything we do on technology.

CUSTOMER ACCOUNT DATA ENGINE

What I was told by overseers is we've made great progress, we've proven that we can do systems development, but they don't see a path to finishing CADE. And the internal projections for finishing were 2015, 2017, 2020. I believe the key to technology projects, the way get them done, is you have leaders—not just technology leaders, but the people who run agencies— focus on them and drive toward those results.

And so what we've done is refocus the effort and split apart all the application work from the database work. If we get the database done, we will get refunds out quicker, we will address material weaknesses, and we will be able to use data for enforcement purposes. So the real business value of CADE comes out of the database; we are focused on getting that done now. And we are slowing down the application development and just focusing on conversion of the database.

The other thing that I think is important from that report that came out is that the vast majority of that \$400 million is being put to good use. The key is getting a data model with consistent definitions used in all of our systems. That was under that umbrella. We put out faster refunds to millions of taxpayers using the money that's been spent. Especially in these difficult economic times, that has been really important. And we are using a huge amount of the software and hardware.

So, this is a gradual shifting of focus. It is what you do with any big technology project, you learn as you go along. I certainly would hope it is not put in a category of failure; I don't believe it has failed at all. I think it's a step in what we can get done during my 5-year tenure. And that is what we are trying to get done.

Senator DURBIN. Thank you. Senator COLLINS.

INFORMATION TECHNOLOGY SECURITY

Senator COLLINS. Thank you, Mr. Chairman. Just one final question and the rest I will submit for the record.

I appreciate the chairman bringing about the CADE strategy because that has been of concern to me. The other issue that concerns me has to do with IT security weaknesses. How much improvement in data protection do you believe the IRS will be able to make with the \$90 million that you are requesting for IT security? Give us your assessment of the vulnerabilities and whether that is, in fact, a sufficient amount to address the problem.

Commissioner SHULMAN. Senator, when I came in, all everyone talked about was modernization. And I actually believe that if you have a big technology portfolio, you need to worry about the current systems, updating those, so that your workers have tools along the way, making sure that there's the right balance between security and infrastructure. You need to worry about data security, especially when you hold the taxpayer records of the United States. And you need to worry about your new systems.

So, one of the things this budget reflects is rebalancing the portfolio so we are not myopically focused on modernization; we care a lot about security and data. There's \$90 million in the budget request to upgrade our security posture and infrastructure. It is incredibly important. I think, knock on wood, we haven't had any major data breaches. There is always going to be a spectrum of weaknesses that overseers are going to point out, and you have to do risk-reward evaluations. You're never going to get every single piece of potential weakness but you have to figure out what is important.

I pay a lot of attention to GAO procedure reports. All development is now new development. We're seeing a lot of laws which are incredibly important for internal threats. We are consolidating our access points into our networks so that we have perimeter security.

A lot of data security is cultural. You want people who have access to data to wake up every day and feel it's their responsibility to lock down the data. So, we had something called Operation Red last year where we stood down every employee of the IRS for 2 hours to talk about what data is under their sphere and what can they do to better protect it, everything from file cabinets to safes to technology.

I would say we are in a better security posture now than when I started. The people who are interested in breaching the security are always going to be innovating, and so we are going to need to stay ahead of the curve. But I think the money requested in this budget will allow us to keep improving in that vein.

Senator COLLINS. Thank you. Thank you, Mr. Chairman.

Senator DURBIN. I'd like to say that the IRS Oversight Board has submitted for inclusion in the record and preliminary recommendations on the fiscal year 2010 IRS budget proposal. The GAO office, at my request, is evaluating the budget proposal and will submit its analysis and recommendations.

Colleen Kelly, president of the National Treasury and Employer's Union on behalf of employers has submitted a written statement. Without objection, these will all be made part of record.

[The statements follow:]

PREPARED STATEMENT OF THE IRS OVERSIGHT BOARD

The Internal Revenue Service (IRS) Oversight Board thanks Chairman Durbin, Ranking Member Collins, and members of the Subcommittee for the opportunity to present the Oversight Board's views on the administration's fiscal year 2010 IRS budget request.

This statement presents the Board's recommendations for the IRS' fiscal year 2010 budget and why the Board believes this level of funding is needed to meet the needs of the country and of taxpayers. Created as part of the IRS Restructuring and Reform Act of 1998 (RRA 98), the Oversight Board's responsibilities include overseeing the IRS in its administration, management, conduct, direction and supervision of the execution and application of the internal revenue laws. The Board is also responsible for ensuring that the IRS' organization and operations allow the agency to carry out its mission. To this end, the Board was given specific responsibilities for reviewing and approving annual budgets and strategic plans.

The Board has a responsibility to ensure that the IRS' budget and the related performance expectations contained in the performance budget support the recently published IRS Strategic Plan 2009–2013. In addition to this statement, the Board develops a formal report in which it explains in detail why it has recommended this budget for the IRS. Because of the late budget cycle caused by the change in administrations, this report is still under development. The Board requests that this report be entered into the meeting record when it is sent to the Subcommittee later this month.

FISCAL YEAR 2010 IRS BUDGET RECOMMENDATIONS

The IRS Oversight Board recommends an fiscal year 2010 IRS budget of \$12.489 billion, an increase of \$966 million over the enacted fiscal year 2009 amount of \$11.523 billion. This recommendation is \$363 million above the President's request of \$12.126 billion.

Tables 1 and 2 at the end of this statement show more information on the Board's budget recommendations. Table 1 shows the program initiatives or increases the Board is recommending, and Table 2 shows the Board's recommended budget by account.

As the Board stated in its 2008 Annual Report to Congress, our tax administration system has two serious weaknesses, the \$290 billion tax gap and the archaic nature of IRS information systems. As a result, the Board recommends that strengthening the system be a national priority.

Addressing those weaknesses is critical and urgent. The Board is fully supportive of the administration's boost in enforcement funding. However, the Board recommends greater funding in the areas of Business Systems Modernization (BSM) and Operations Support than the President's budget requests. While the Oversight Board and the administration's budgets agree in many ways, the Board feels that these key additional investments are needed sooner—not later—to strengthen our tax administration system.

The effort required to correct the two weaknesses identified above is not to be taken lightly. Although the tax gap can never realistically be eliminated, it is equally as foolish to suggest that nothing can be done to reduce it. As the Board has opined on numerous occasions, there is not a single solution to reducing the tax gap. Rather, a comprehensive, multi-faceted, multi-year, approach is needed that provides for excellent taxpayer service combined with vigorous enforcement, along with a long-term investment in IRS information technology and infrastructure. It is generally recognized that the IRS "cannot audit its way out of the tax gap." Balance between immediate expansion of personnel combined with long term investments in information technology and infrastructure is needed.

The second weakness, modernizing the IRS' archaic information technology systems, is equally daunting—yet it must be done. As noted in the Board's 2008 Annual Report to Congress, the IRS' systems modernization program has been on the Government Accountability Office's (GAO's) high risk list since 1995. The GAO placed this program on its high risk list because it believed that the IRS relied on obsolete automated systems for key operational and financial management functions. The Board believes that it is unacceptable for this program to remain on the high risk list for so long is unacceptable.

The Board believes strongly that the IRS' BSM program must be in a position to move forward in fiscal year 2010 and fiscal year 2011 so that program milestones scheduled for 2011 can be achieved. Because the President's budget provides little additional funding for the Customer Account Data Engine in fiscal year 2010, it

puts the fiscal year 2011 milestones at great risk. In addition, the Board believes additional funding is needed to refresh and update the IRS' aging infrastructure. In total, of the \$363 million difference in the two budgets, about \$332 million is for investments in critical information technology and infrastructure.

The Board would also increase funding for several key initiatives to improve taxpayer service. These initiatives are all designed to help the IRS plan and implement better taxpayer service in the future.

Board Fully Supports Increased Enforcement Funding

The Board's recommendation for the enforcement account, which at \$5.5 billion is close to half of the IRS total budget, is identical to the President's budgets. Both the President's and Oversight Board's budgets add \$332 million for additional enforcement. This increase constitutes a 7.6 percent boost in enforcement funding, and includes additional funding to strengthen criminal investigations programs, increase examinations and collections, and support a variety of regulatory matters.

This increase in enforcement resources pays for itself, in some cases many times over—a consideration that should not be ignored in the budget process. In addition, it helps to reduce the tax gap, which deprives the nation, and hence its citizens, of \$290 billion it is legally owed. The tax gap is an affront to honest taxpayers and efforts must be made to reduce it.

The President's request for enforcement funding includes a multi-year investment of \$128 million, starting in fiscal year 2010, to deal more effectively with increasing international tax activities of individual and business taxpayers. The Board is pleased with this, as the effects of globalization on tax administration are significant and must be addressed.

The Board also strongly supports additional funding to improve compliance among "high-risk" taxpayer segments. Estimates shows that much of the tax gap is due to underreporting of income by businesses, mostly run by individuals. It is imperative that the IRS not only ensure that all individuals understand their tax obligations, but that they report their income and pay their taxes.

Taxpayer Service Increase Recommended

For the taxpayer service account, the Oversight Board's and President's budgets are within 0.2 percent of one another. The President's budget request for taxpayer service benefits from congressional action taken during consideration of the fiscal year 2009 budget. By adding additional funding to the IRS taxpayer service budget in fiscal year 2009, Congress raised the base amount for taxpayer service in fiscal year 2010, giving the IRS additional resources to serve taxpayers in an increasingly more complex economic environment.

The need for taxpayer service is especially acute during periods of economic hardship, as taxpayers may find themselves facing challenging financial situations. In addition, taxpayers need additional help to understand new tax provisions and programs designed to help them during difficult times. Every change in the tax code causes the tax administration system to become more complex, with more taxpayers in need of help to understand and meet their obligations. It is especially important during this recession that the IRS be able to follow through on its strategic goal to "make voluntary compliance easier."

Despite a higher funding base for taxpayer service, there are several areas where the Board recommends additional funding. In 2005, Congress asked the IRS, National Taxpayer Advocate, and the IRS Oversight Board to develop a 5-year plan to improve taxpayer service. The result was the Taxpayer Assistance Blueprint (TAB), which was completed in April 2007. In the Board's opinion, the IRS needs additional resources to more fully carry out the TAB by expanding its on-line capabilities. Additional funding is also needed to optimize the use of Taxpayer Assistance Centers, also known as walk-in sites, which traditionally serve lower income taxpayers who depend more on walk-in services. Overall, the Board recommends an additional \$31.6 million be appropriated for taxpayer service, all of which will be focused on improving taxpayer service in the future.

Strategic Funding Needed for Business Systems Modernization

The IRS' archaic computer systems are a serious challenge facing the IRS. The Board is dismayed by the long-term under-funding of the BSM program, forcing the IRS to stretch out its efforts at a painfully slow pace, to the detriment of taxpayers.

The Board is pleased that the IRS has revised its BSM approach to put more focus on completing the program, and considers it a critical foundation of service and enforcement in the future.

However, the Board questions whether the President's budget will allow for substantive progress in the coming years. The Board has opined in past years that the BSM account is fundamentally under-funded, and despite the additional \$7.3 million

added by Congress in fiscal year 2009 and the President's fiscal year 2010 requested increase of \$22.6 million, the fiscal year 2010 request for BSM continues to be far too low. Progress will come slowly should that trend continue. The Customer Account Data Engine project, in particular, has funding needs that go far beyond what was requested in fiscal year 2010, and those needs will only grow in fiscal year 2011.

The Board's recommended BSM budget of \$400 million is 58 percent higher than the President's BSM budget of \$253.7 million. At \$253.7 million, the President's BSM budget consumes 2.1 percent of the IRS total budget of \$12.126 billion. This compares to the Board's recommendation of a \$400 million BSM budget, which consumes 3.2 percent of its total \$12.489 billion budget. Although the difference is quite small when viewed as a portion of the total budget, the vision presented by these two BSM budgets is quite different. The Board believes that funding decisions for the IRS must look beyond consideration of short term benefits and immediate return on investment. Serious consideration must also be given to the long term benefits to taxpayers and the tax administration system that will result from a modernized information technology system. These investments will result in fundamental changes to tax administration that will benefit both taxpayers and tax administrators alike.

The Board recommends that a total of \$400 million be appropriated for the BSM program so that the pace of progress is increased, allowing the IRS to achieve key milestones in fiscal year 2011, such as the deployment of a daily Individual Master File capability and a Customer Account Data Engine relational database.

More Funding for Operations Support

Another important aspect of the IRS' performance is the state of its legacy infrastructure: the technology and tools used by IRS employees to do their work. IRS laptops, software, the telecommunications systems, and the buildings themselves are aging and must be updated and maintained. In addition, the IRS must protect its hardware and data infrastructure from threat, whether it comes from bad weather or cyber-attack.

The administration's fiscal year 2010 budget calls for \$108.1 million in program increases to address information technology security and material weaknesses and to strengthen the Electronic Fraud Detection System. The Board supports this funding, as both can help ensure the integrity of the tax system and maintain taxpayer confidence that its returns remain private and safe from security risks.

However, more needs to be done. The Board recommends a total of \$292 million in infrastructure program initiatives, compared to the \$108 million requested by the President's IRS budget. The Board recommends an additional \$164 million in technology initiatives and a \$20 million initiative related to workforce development. This funding is needed to refresh and maintain the IRS' infrastructure, strengthen its ability to protect the personal information of taxpayers, increase the productivity of its workforce by leveraging information technology, and upgrade its financial services accounting system that uses a software application product that is so old the vendor will no longer support the program in 2013.

In addition, workforce development cannot be ignored, especially during a period when the IRS is losing experienced employees to retirement and is hiring a significant number of new employees. Frontline supervision plays a key role in employee satisfaction, quality, and productivity, and the IRS lacks funding to properly train frontline managers in a timely fashion. Approximately \$15 million of the workforce initiative is for frontline management training, with the remaining \$5 million for succession planning and executive development.

Long-Term Investment Key to IRS Strength

Although the magnitude of the Board's budget recommendations for the IRS are not vastly different from the President's budget request in amount, they do focus more on the IRS' strategic goals and call for investments that are needed today for a stronger tax administration system in the future. The Oversight Board believes that its approach represents a meaningful long-term investment to benefit our Nation in the decades to come.

TABLE 1.—IRS OVERSIGHT BOARD RECOMMENDED FISCAL YEAR 2010 IRS BUDGET BY PROGRAM INITIATIVE

[In thousands of dollars]

Fiscal Year 2009 Enacted	11,522,598
--------------------------------	------------

TABLE 1.—IRS OVERSIGHT BOARD RECOMMENDED FISCAL YEAR 2010 IRS BUDGET BY PROGRAM INITIATIVE—Continued
[In thousands of dollars]

Changes to Base:	
Maintaining Current Levels	256,329
Efficiencies/Savings	(118,125)
Reinvestment	2,331
Subtotal Changes to Base	140,535
Total Fiscal Year 2010 Base—Current Services	11,663,133
Program Increases	
Taxpayer Service Initiatives:	
TAB Technology Enhancements	6,000
Optimize TAC Footprint	17,880
Research and Analysis to Improve Taxpayer Service	7,750
Subtotal, Taxpayer Service Initiatives	31,630
Program Increases	
Enforcement Initiatives:	
Reduce the Tax Gap Attributable to International Activities	128,064
Improve Reporting Compliance of SB/SE Taxpayers	94,215
Expand Document Matching for Business Taxpayers	26,237
Address Nonfiling/Underpayment and Collection Coverage	83,644
Subtotal, Enforcement Initiatives	332,160
Infrastructure Initiatives:	
Address IT Security and Material Weakness	90,000
Implement Return Review Program	18,100
Refresh/Sustain Infrastructure	75,000
Training and Certifying Project Managers	5,000
Enhance Privacy, Information Protection and Data Security	9,154
Technology Investments to Enhance Operations	35,000
Upgrade Integrated Financial System (IFS)	40,700
Leadership Training and Development	20,000
Subtotal, Infrastructure Initiatives	292,954
BSM Initiative:	
Fund BSM to Accelerate Taxpayer Benefits	168,933
Subtotal, BSM	168,933
Subtotal Fiscal Year 2010 Program Initiatives	825,677
Total Fiscal Year 2010 Request	12,488,810
Fiscal Year 2010 President's Request for IRS	12,126,000
Increase Over President's Request	362,810

TABLE 2.—SUMMARY OF OVERSIGHT BOARD RECOMMENDED IRS FISCAL YEAR 2010 BUDGET BY ACCOUNT
[Dollars in thousands]

	Taxpayer Service	Enforcement	Ops Support	BSM	HITCA	Total
Fiscal Year 2009 Enacted Budget	\$2,293,000	\$5,117,267	\$3,867,011	\$229,914	\$15,406	\$11,522,598
Changes to Base:						
Maintaining Current Levels Adjustment	\$60,195	\$133,815	\$61,060	\$1,153	\$106	\$256,329
Efficiencies/Savings	(\$90,918)	.....	(\$27,207)	.....	.....	(\$118,125)
Reinvestment	\$2,025	.....	\$306	.....	.....	\$2,331
Subtotal Changes to Base	(\$28,698)	\$133,815	\$34,159	\$1,153	\$106	\$140,535
Total Fiscal Year 2010 Base—Current Services	\$2,264,302	\$5,251,082	\$3,901,170	\$231,067	\$15,512	\$11,663,133
Program Increases						
Taxpayer Service Initiatives:						
TAB Technology Enhancements	\$592	.....	\$5,408	.....	.....	\$6,000
Optimize TAC Footprint	\$4,238	.....	\$13,642	.....	.....	\$17,880
Research and Analysis to Improve Service .....	.....	.....	\$7,750	.....	.....	\$7,750
Subtotal, Taxpayer Service Initiatives	\$4,830	.....	\$26,800	.....	.....	\$31,630
Enforcement Initiatives:						
Reduce the Tax Gap Attributable to International Activities .....	.....	.....	.....	.....	.....	.....
Improve Reporting Compliance of SB/SE Taxpayers	\$3,124	\$104,113	\$20,827	.....	.....	\$128,064
Expand Document Matching for Business Taxpayers	\$267	\$75,114	\$18,834	.....	.....	\$94,215
Address Nonfiling/Underpayment and Collection Coverage	\$1,425	\$17,955	\$6,857	.....	.....	\$26,237
Subtotal, Enforcement Initiatives	\$5,528	\$252,918	\$27,196	.....	.....	\$83,644
Infrastructure Initiatives:						
Address IT Security and Material Weakness .....	.....	.....	\$73,714	.....	.....	\$332,160
Implement Return Review Program (RRP) .....	.....	.....	\$90,000	.....	.....	\$90,000
Refresh/Sustain Infrastructure .....	.....	.....	\$18,100	.....	.....	\$18,100
Training and Certifying Project Managers .....	.....	.....	\$75,000	.....	.....	\$75,000
Enhance Privacy, Information Protection and Data Security .....	.....	.....	\$5,000	.....	.....	\$5,000
Technology Investments to Enhance Operations .....	.....	.....	\$9,154	.....	.....	\$9,154
Upgrade Integrated Financial System (IFS) .....	.....	.....	\$35,000	.....	.....	\$35,000
Subtotal, Infrastructure Initiatives .....	.....	.....	\$40,700	.....	.....	\$40,700

[illegible]

PREPARED STATEMENT OF COLLEEN M. KELLEY, NATIONAL PRESIDENT, NATIONAL
TREASURY EMPLOYEES UNION

Chairman Durbin, Ranking Member Collins, and distinguished members of the Subcommittee, I would like to thank you for allowing me to provide comments on the administration's fiscal year 2010 budget request for the Internal Revenue Service (IRS). As President of the National Treasury Employees Union (NTEU), I have the honor of representing over 150,000 federal workers in 31 agencies, including the men and women at the IRS.

IRS FISCAL YEAR 2010 BUDGET REQUEST

Mr. Chairman, NTEU strongly supports the administration's fiscal year 2010 budget request of \$12.1 billion for the IRS, a roughly \$600 million increase over fiscal year 2009 levels. We believe that the President's request will allow the IRS to continue providing taxpayers with top quality service and will assist efforts to enhance taxpayer compliance and close the tax gap.

We are particularly pleased the administration's budget request would provide \$5.5 billion for IRS tax enforcement, including additional resources made available through a program integrity allocation adjustment. According to the administration, IRS enforcement efforts recoup \$5 for every \$1 dollar invested and the program integrity savings from increased investment for IRS enforcement efforts will be more than \$13 billion between 2010–2014.

We are also pleased to see the recently passed budget resolution fully funds the President's budget request for the IRS and includes the President's request for additional resources for IRS tax-law enforcement.

I would also note that in previous years, NTEU has supported the budget recommendations proposed by the IRS Oversight Board which have generally called for additional resources above that requested by the administration. For fiscal year 2010, the Oversight Board has recommended \$12.961 billion in funding for the IRS. While we have not seen the specific details of the Board's updated proposal, we would be inclined to support providing additional funding for the IRS above the administration's request and look forward to reviewing the Board's final recommendation.

MAJOR CHALLENGES

Mr. Chairman, NTEU believes the President's request will allow the IRS to meet its customer service and enforcement challenges while also addressing some of the most immediate challenges it will face in the coming years, including the growing human capital crisis, increasing complexity of tax administration, and a burgeoning tax gap.

HUMAN CAPITAL CRISIS

NTEU believes that IRS employees are the most valuable asset in effective tax administration. We are glad to see that the IRS Strategic Plan for 2009–2013 recognizes this fact and stresses the importance of investing in the workforce in order to achieve its service and enforcement goals. But as the IRS notes, they face several major challenges such as large numbers of retirements and competition with both the public and private sectors for critical talent. According to the IRS, more than half of IRS employees and managers are age 50 or older. The expected large scale retirements of thousands of Service personnel over the next several years will only further deplete the decimated IRS workforce that is down by more than 23,000 since 1995. According to a report by the IRS Oversight Board, an independent body charged with providing IRS with long-term guidance and direction, roughly 4,000 IRS employees a year for the next four years are expected to retire, taking with them years of experience and valuable skills. The dramatic decline in staffing levels coupled with the pending retirement wave has caused the Oversight Board to identify human capital issues as one the most important strategic challenges facing the IRS.

In the face of an aging workforce and looming wave of retirements, Commissioner Shulman created the Workforce of Tomorrow task force to ensure that in five years the IRS has the leadership and workforce ready for the next 15 years and to help make the IRS the best place to work in government.

NTEU was happy to see that the President's budget request acknowledges the human capital crisis at the Service and provides for major increases in Service staffing, particularly in the area of enforcement. According to the administration, the new enforcement personnel funded in the President's budget will generate \$2.0 bil-

lion in additional annual enforcement revenue once the new hires reach full potential in fiscal year 2012.

INCREASING COMPLEXITY OF TAX ADMINISTRATION

Under the President's budget request, the IRS will also be better equipped to handle the challenges associated with the increasingly complexity of tax administration. For example, one of the biggest challenges the IRS confronts each year is identifying new tax law and administrative changes as well as expiring tax provisions. According to the IRS, in 2007 alone, 41 tax provisions expired affecting a wide range of taxpayers.

During the 2009 Filing Season, the IRS was presented with additional challenges due to the enactment of two significant new tax laws, the "Housing and Economic Recovery Act of 2008," which includes a refundable homebuyer credit as well as an additional standard deduction for real property taxes, as well as the "Emergency Economic Stabilization Act of 2008," which included 116 different tax provisions.

In the future, the IRS will also be confronted with the challenges presented by the increasing globalization of individual taxpayers and businesses. As more and more U.S. taxpayers and businesses expand into global markets, it will be important that the IRS has the technical expertise to identify and understand the proliferation of complex international activities and the emerging global nature of tax administration.

TAX GAP

Recent and projected large Federal budget deficits have generated congressional and executive branch interest in raising revenue by reducing the tax gap, that is, the difference between what taxpayers should have paid and what they actually paid on a timely basis. For tax year 2001, the IRS estimated a gross tax gap of \$345 billion, equal to a noncompliance rate of 16.3 percent.

NTEU believes that efforts to close the tax gap must focus on improving compliance activities and enhancing taxpayer service. By improving document matching, examination, and collection activities, the IRS will be better able to prevent, detect, and remedy noncompliance. And providing taxpayers with assistance and clear and accurate information before they file their tax returns will help reduce unnecessary contacts afterwards, allowing IRS to focus enforcement resources on taxpayers who are intentionally evading their tax obligations.

In addition to generating additional revenue for the Federal Government, reducing the tax gap will help strengthen public trust in the fairness of the tax system which will positively impact voluntary compliance with tax laws.

That is why NTEU supports the President's request for an additional \$332 million to help close the tax gap by strengthening compliance and allowing the IRS to better address the main components of the tax gap including, underreporting, non-filing and underpayment.

ENFORCEMENT

Mr. Chairman, as you know enforcement of the tax laws is an integral component of IRS' effort to enhance voluntary compliance and close the tax gap. IRS enforcement activities, such as examination and collection, target elements of the tax gap and are a high priority for the Service. In fiscal year 2008, the IRS initiated additional information reporting requirements for large partnerships and foreign corporations, soft notices and self-correction to improve compliance.

These efforts helped the IRS bring in \$56.4 billion in enforcement revenue in 2008, a 65 percent increase over fiscal year 2002. The \$56.4 billion in collections in 2008 represents a 5 to 1 return on investment for all IRS activities. In addition, the IRS showed consistent improvement in its enforcement results meeting or exceeding 78 percent (14 of 18) of its program targets.

Most impressively, the IRS continues to bring in record amounts of enforcement revenue despite severe cuts to enforcement staffing over the past 13 years. In particular, the number of revenue officers and revenue agents—two groups critical to closing the tax gap and thereby reducing the Federal budget deficit—have shrunk by 33 and 20 percent respectively. Revenue officers went from 8,139 to 5,481 and revenue agents fell from 16,078 to 12,951. As noted previously, these drastic cuts have come at a time when the IRS workload has increased dramatically due to the increasing complexity of tax administration.

NTEU believes it is essential that the IRS continue to direct resources toward enforcement activities that have the greatest overall impact on compliance and can best aid the Service's efforts to close the tax gap. One such activity is the IRS Automated Underreporter (AUR) program which has evolved as an important Service

compliance initiative using third-party information returns to identify income and deductions that were not reported on tax returns. NTEU believes the program is an effective way to detect taxpayer underreporting which accounts for roughly 82 percent of the gross tax gap.

In fiscal year 2008, increased AUR contact closures increased by almost 4 percent from the previous year and dollars collected through AUR and information return processing increased by 22 percent.

The administration's budget request acknowledges the import role the AUR program can have in closing the tax gap by reducing the number of taxpayers who underreport their income and proposes an increase of \$26.2 million and 300 FTE to increase coverage of the AUR document matching program. According to the administration, this request will generate \$386.5 million in additional revenue once new hires reach full potential in fiscal year 2012 resulting in a return on investment (ROI) of 17 to 1.

TAXPAYER SERVICE

Mr. Chairman, NTEU strongly believes that providing quality customer service to the taxpayer is an important part of IRS efforts to help the taxpaying public understand their tax obligations while making it easier to participate in the tax system. Through many sources, the IRS provides year-round assistance to millions of taxpayers, including outreach and education programs, issuance of tax forms and publications, rulings and regulations, toll-free call centers, the IRS.gov web site, Taxpayer Assistance Centers (TACs), Volunteer Income Tax Assistance (VITA) sites, and Tax Counseling for the Elderly (TCE) sites. These efforts have helped the IRS raise their standard of service to America's taxpayers and assisted in efforts to improve voluntary compliance. The IRS has continued to make great strides in recent years in the quality of the service it provides despite relatively flat budgets, that when adjusted for inflation, have provided the IRS with fewer resources over the past several years compared to fiscal year 2002.

But despite receiving fewer resources and continued reductions in the number of customer service representatives at the Service, the IRS was able to deliver a successful 2008 filing season. As you know, the 2008 filing season was particularly challenging due to late enactment of the AMT legislation and implementation of the Economic Stimulus Payment program. Despite these challenges, the IRS carried out another successful filing season during which IRS employees processed more than 155 million individual returns including returns filed solely to claim an economic stimulus payment, an increase of 11 percent over last year and issued 107.6 million refunds, totaling \$369 billion; answered over 40.4 million calls, an increase of 21 percent due to a large increase in taxpayer inquiries about the economic stimulus checks; completed 52 million automated calls, an increase of over 123 percent; maintained account and tax law accuracy rates of over 90 percent and expanded return preparation at IRS Taxpayer Assistance Centers (TACs) preparing over 575,000 returns, a 42 percent increase over last year.

Mr. Chairman, while IRS employees were able to continue providing quality service to taxpayers in fiscal year 2008, we do have concerns about the potential negative effect on IRS' ability to continue doing so should the "efficiency savings" assumed in the administration's budget request not materialize. For fiscal year 2010, the budget request identifies "efficiency savings" of more than \$118 million at the cost of 1,504 FTE's. If, as sometimes been the case in previous years, IRS fails to realize all expected savings then the funds available for critical Service personnel, such as those working at the 401 TACs located nationwide, would be further reduced.

As stated previously, NTEU strongly believes providing quality service to taxpayers is critical to ensuring taxpayers understand their tax obligations while making it easier for them to participate in the tax system. And in the current economic climate, we believe it is more important than ever that taxpayers be able to deal with the IRS directly to work through any financial difficulties they may encounter. IRS employees have a wide range of tools and information at their disposal, which allow them to work with taxpayers to address their financial hardships and to become compliant.

Above all else, the IRS employee's interest is in assisting struggling taxpayers to meet their tax obligations in a way that will not exacerbate their financial distress. When an IRS employee works with a taxpayer, the employee has access to all of the taxpayer's information and can answer questions and offer advice. For example, they can see whether a taxpayer has not filed a return and explain that the sooner the taxpayer makes arrangements to address filing and balance due issues the less penalty and interest they will owe. They can look at the taxpayer's records and an-

answer questions about why they owe a balance and what they can do about it. They can also tell the taxpayer that they are not having enough taxes withheld by their employer and need to address that or that if an ex-spouse is claiming a child as a dependent they will not also be able to receive an exemption. If a simple mistake, like a math error, has occurred, they can fix it. They can provide an extension of the time period for payment. They can make a determination that the taxpayer meets the currently not collectible requirements or whether the taxpayer may be eligible for an Offer in Compromise, in which part of the balance due is foregone.

NTEU believes providing quality services to taxpayers is an important part of any overall strategy to improve compliance and that the President's request for taxpayer services will enable the IRS to deliver another successful filing season, improve the responsiveness and accuracy of taxpayer service, and support Service efforts to enhance taxpayer compliance.

SECTION 1203

Mr. Chairman, while meaningful funding for the IRS is important to operations, NTEU also believes that in order to maximize efficiencies at the IRS, Congress must act to modify Section 1203 of the IRS Restructuring and Reform Act of 1988 (RRA 98). Commonly known as the "Ten Deadly Sins," Section 1203 outlines ten infractions for which IRS employees must be fired, including the untimely filing of Federal income taxes even when a refund is due. No other Federal or congressional employee is subject to similar mandatory termination.

Without question, Section 1203 has had a negative impact on the morale of the IRS workforce and is impeding the ability of the IRS to perform its mission. According to numerous GAO reports, IRS employees greatly fear the threat of being fired under Section 1203. This in turn has had a chilling effect on the ability of IRS employees to do their jobs. In particular, employees specifically attribute the decrease in recommending a seizure of taxpayer's assets to Section 1203. Clearly, Section 1203 impedes IRS' enforcement mission and is unfair to the IRS employees who must work under the constant threat of losing their jobs.

NTEU believes mandatory termination for Section 1203 violations is unduly harsh and should not be the only disciplinary action available. We advocate amending RRA 98 to allow for appropriate penalties other than mandatory termination for Section 1203 violations and to allow for independent review of determinations.

To be clear, NTEU does not condone any violation of law or rules of conduct by its members at the IRS or in any other government agency. Violations of some rules clearly warrant termination of employment. However, one group of Federal employees should not be singled out and required to be fired for offenses that do not subject other executive, judicial, or legislative branch employees to the same penalty.

Mr. Chairman, the large majority of IRS employees work hard, follow the rules and pay their taxes on time. It is patently unfair to hold those who are charged with enforcing the tax laws to a higher standard than those who write them. NTEU asks for your support for changes to section 1203 of the IRS Reform and Restructuring Act, so that tax fairness applies to all Americans, even those who work at the IRS.

CONCLUSION

Mr. Chairman, thank you for the opportunity to provide NTEU's thoughts on the administration's fiscal year 2010 budget request for the IRS. We believe that by investing in the IRS workforce and demonstrably effective enforcement and taxpayer service programs, the administration's request will ensure the IRS continues to meet its mission of providing America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. The record will remain open, Mr. Commissioner, until Wednesday, June 17, for subcommittee members to submit statements and questions to be submitted to you for consideration.

[The following questions were not asked at the hearing, but were submitted to the Service for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

MEASURING RETURN ON INVESTMENT: NEW INITIATIVES

Question. In your fiscal year 2010 budget request, the IRS seeks \$332 million for new enforcement initiatives projected to yield direct measurable results through high return-on-investment. The proposed investments in enforcement personnel in fiscal year 2010 are expected to yield \$2 billion in additional annual enforcement revenue once new hires reach their fully trained potential in fiscal year 2012.

GAO's review and written assessment of the proposed budget observes, with concern, that the IRS has no plans to compare the actual performance to the projections.

Would it not be prudent and beneficial to determine the extent to which your revenue forecasts were accurate and the yield was realized?

Answer. The IRS maintains a historical record of enforcement revenue produced by its enforcement programs at an aggregate level, and the IRS uses this historical revenue information to estimate future revenue produced from proposed enforcement initiatives in budget requests and to compare its estimated revenue projections with actual revenue. Actual annual enforcement revenue is analyzed to determine factors causing variance from expected results. For example, analysis of fiscal year 2007 enforcement revenue indicated that the increase from \$48.7 billion in fiscal year 2006 to \$59.2 billion was primarily the result of two large settlements.

While the IRS does compare the actual performance to the projections at the aggregate revenue level, specific examination and collection activities are fungible, and therefore, it is difficult to isolate the revenue attributable to a specific initiative. The IRS uses its existing suite of performance measures as a tool for managing its activities. IRS performance measure results, including examination and collection coverage, are a better gauge of the efficiency and effectiveness of existing programs.

Question. Assuming that Congress is able to provide these funds as requested and the IRS proceeds with the initiatives planned, how will we know whether this was a wise investment?

Answer. At full performance levels in fiscal year 2012, the additional enforcement personnel will produce additional revenue and increases in performance measures in examination and collection as presented in the fiscal year 2010 budget request. For example, the number of audits in targeted categories is projected to increase, and the number of collection accounts resolved is expected to increase, both resulting in increased revenue. The IRS expects these initiatives to yield a return-on-investment (ROI) of 7.8 to 1 once they reach full potential.

Question. Do you agree that knowing what actually happens as a result of these targeted investments would be a helpful indicator of success and useful in making future spending decisions and resource allocation plans?

Answer. The IRS will continue to collect actual cost and revenue data associated with high-level enforcement programs, and will continue to analyze actual enforcement revenue results to refine future projections for budget initiatives, as needed.

The IRS uses actual enforcement revenue from prior years to calculate its Return on Investment figures (ROIs) for proposed enforcement initiatives. The ROIs are based on rolling, 10-year averages of enforcement revenue produced by specific enforcement functions with greater weight placed on the most recent year revenue. The IRS bases revenue estimates on historical yield per FTE, which it evaluates and updates annually.

Question. Will IRS collect data to determine the actual costs, revenues, and ROI to determine whether the investment produced the anticipated results? If "NO"—what is the IRS's rationale for not keeping track of the actual return on investment of these new initiatives?

Answer. As stated above, the IRS does collect actual cost and revenue data associated with high-level enforcement programs and uses the cost and revenue data to develop its proposed budget initiatives. Tracking the revenue produced by each initiative hire is not possible. For example, each new international examiner will work on a mix of cases which could include audits that are not associated with the initiative because of shifting work priorities or the emergence of new international issues. Additionally, the new international examiner will work on cases as part of an audit team. Apportioning actual revenue resulting from a team audit to various audit team members, who may or may not be an initiative hire, is not feasible. Initiative hires work on a variety of tasks and on group audits, and as a result, tracking the revenue derived from a specific initiative hire is not possible, but the revenue is tracked and analyzed for high-level enforcement programs.

DETERRENT EFFECT OF ENFORCEMENT INITIATIVES

Question. In addition to the direct revenue impact of such an investment, isn't there a deterrent effect?

Answer. Yes. Several empirical studies have indicated that the "deterrent" effect from enhanced enforcement efforts could be larger (perhaps much larger) than the direct revenue effect.

Question. How does IRS measure deterrent effect? What is the estimate?

Answer. By the "deterrent" effect of an IRS activity, we mean the change in voluntary compliance—both subsequent compliance by a person directly contacted as a part of that activity and changed compliance behavior by the population in general—that is prompted by an expansion or intensification of that IRS activity. More generally, the IRS refers to this phenomenon as the "indirect" effect since deterrence may not always be the mechanism at work. For example, the general population may demonstrate improved voluntary compliance in response to expanded prosecutions of tax criminals, but not because they fear being caught committing tax crimes; rather, the expanded prosecutions may reassure the average taxpayer that criminals are receiving justice, which makes the average taxpayer more likely to pay his or her taxes in full. Likewise, IRS's services to taxpayers may have a positive effect on the voluntary compliance of those who do not receive those services, but who hear positive reports from those who do.

We can observe the compliance behavior of each taxpayer, but that behavior is driven by a complex set of factors (including things outside of IRS control, such as economic, demographic, and socio-political factors) that vary widely across the population. We cannot observe how many dollars are paid as a result of each of those factors separately; we can only attempt to estimate that. Several academic studies have attempted to estimate the indirect effect of audits, and a few have also estimated the effect of criminal investigations and other IRS activities, but since all of these statistical studies have limitations and weaknesses, there has not yet formed a consensus as to the true indirect effect of these or other IRS activities. The estimates that exist for the indirect effects range from approximately zero to over 10 times the magnitude of the direct effect.

Question. Are there particular remedial actions or collection interventions that IRS uses that you have found to be more conducive or effective than others when it comes to deterrent effect?

Answer. There is some limited statistical evidence that audits of individuals are quite cost-effective in generating an indirect effect (partly because they are less costly to complete than activities such as criminal investigations or complicated corporate audits). The IRS is continuing to research the indirect effects of both enforcement and service activities in an effort to allocate resources optimally.

ELECTRONIC FILING—STAFFING SHIFTS

Question. The IRS budget for fiscal year 2010 reflects that due to increased e-filing options there will be an expected decline of 4.6 million in the number of paper returns filed, resulting in a savings in submission processing of 187 FTE. The IRS is also consolidating its individual return processing centers to achieve efficiency as the paper return volume drops. The IRS is slated to ramp-down its processing center in Andover, Massachusetts and plans to reinvest \$2.3 million to fund a one-time severance payment for employees.

How is the IRS transforming its workforce to adapt to 21st century?

As the volume of e-filing grows, what is the IRS doing to facilitate retraining of processing staff to perform different activities and functions?

Answer. One of the IRS' top priorities is to support the Submission Processing employees whose jobs are affected by site consolidation. Though some of the information included below is specific to the Andover, MA site that is scheduled to close in September 2009, the actions taken are representative of the efforts that have been made with each consolidation and demonstrate the IRS' strong commitment to provide all employees with a wide range of options.

Mitigation Strategies to Minimize Employee Impact

A number of mitigating strategies are used to assist employees in minimizing the impact of consolidation. These strategies are generally broken down into two distinct groups:

Formal strategies—outlined in Article 19 (Reduction in Force and Mitigation Strategies) of the 2006 National Agreement between IRS and NTEU, these strategies are available to employees 1 year prior to the projected Reduction in Force date.

Other strategies—undertaken outside of Article 19 to focus on preparing employees for the consolidation. Many of these strategies begin prior to the onset of the required Article 19 strategies.

Formal strategies include:

- Reassignment Preference Notice (RPN)—entitles directly affected employees to priority selection for vacant positions for which they apply and qualify, either at their same or lower grade Servicewide, i.e. both within and outside the employee's commuting area.
- Voluntary Early Retirement Authority/Voluntary Separation Incentive Payment (VERA/VSIP)—provides an opportunity for eligible employees to separate from the Service early and receive a buyout.
- Severance Pay—received by those employees who are separated via a RIF and are not eligible to retire.
- Job Swaps—per Article 19, directly affected employees may swap jobs into other occupied positions, either inside or outside the commuting area.
- Outplacement Services—employees are granted administrative time to participate in outplacement and career services.
- Relocation to “Follow Your Work”—allows directly affected employees who occupy positions to be abolished to voluntarily relocate and be realigned to a vacant position in a continuing site to perform the work that the employee is currently performing.
- Career Transition Assistance Program (CTAP)—grants the affected employee selection priority for any internal vacancy for which s/he applies and is determined to be well-qualified.
- Inter-Agency Career Transition Assistance Program (ICTAP)—grants affected employees selection priority for any external Federal Government vacancy for which s/he applies and is determined to be well-qualified.
- Grade and Pay Retention—provided to affected employees who are selected for a position not more than three grades below their current grade.

Other Strategies include:

- Identifying work that can be consolidated or redirected into continuing sites.
- The following summarizes the positions created through these efforts:

	Positions
Brookhaven:	
Centralized Offer in Compromise	325
Campus Support Department	140
Memphis:	
Centralized Offer in Compromise	350
Case Processing	325
Campus Support Department	90
Philadelphia:	
Centralized Insolvency	280
Case Processing	230
Campus Support Department	180
Andover:	
Automated Underreporter	¹ 200
Campus Support Department	89

¹ With plans to grow to about 300–400 total.

- Communications—numerous vehicles are used to keep employees updated on the consolidation plan and to assist employees in minimizing the impact of consolidation, including:
 - Newsletters—the Andover campus developed and distributed a publication titled “Changing Times” to employees on a regular basis beginning in February 2008. The issues have addressed various consolidation issues and include employee Q&A’s.
 - Webpage—info included on Andover SP webpage includes newsletters, FAQ’s, and information on Article 19.
 - Employee Meetings—management holds routine meetings with employees to provide consolidation updates and ensure employees are aware of the effect consolidation will have on their current and future positions.
 - Flyers and handouts—will cover topics such as buyouts, early outs, and job swaps.
 - Info to employees in non-work status—pertinent information is mailed to seasonal employees in non-work status.

- Training—provided on various topics to assist employees in continuing with or finding new employment, including:
 - How to apply for positions on USAJobs, the official job site of the federal government.
 - How to prepare a résumé.
 - How to interview for a job.
 - How to apply for a job swap (will be conducted in Andover at a later date).
- Term Hiring—In an effort to minimize the employee affect from consolidation, sites scheduled to consolidate began hiring Term employees at least 2 years prior to consolidation. The Andover site initiated this practice in 2003, 6 years prior to consolidation. This hiring practice has helped to mitigate the effect of consolidation on our career and career conditional employees by limiting the number of potential applicants for continuing positions on the campus. Andover is the first consolidating site where the number of Term employees exceeds the number of career conditional employees.
- Job Fairs—job fairs include employers from the private sector and IRS Business Units that will remain at the campus after consolidation.
- Tuition Assistance—program offered to all IRS employees to assist them in gaining the skills needed for continued employment.
- Mock Interview Cadre—established to assist Andover employees with upcoming interviews.
- Link Line—a phone number established for Andover employees in non-work status to receive information on W&I job openings in Andover Posts of Duty.
- Career Link—Andover IRS is partnering with local Department of Labor to establish an office within Andover IRS office to provide career guidance, employment workshops, and reemployment assistance.
- Computer Kiosks—set up in Andover Posts of Duty for employees without access to a computer to look for job vacancies or update their Merit Promotion Questionnaire's (MPQs).
- Employee Meetings—One-on-One meetings have been held with every employee in Andover SP to determine future plans (i.e. continued employment, retirement, etc.) and provide information related to MPQ assistance, Mock Interviews, etc.
- Job Vacancies—Weekly Career Opportunity Listing (COL) and USAJobs vacancy announcements distributed to SP Operations for dissemination to all employees, in order to keep them informed of potential jobs, both internally and throughout the government.
- Employee Assistance Program (EAP) representatives are in attendance at each RIF briefing and have committed to provide extended services to SP employees during this transition.

QUESTION SUBMITTED BY SENATOR FRANK R. LAUTENBERG

Question. Federal receipts at the U.S. Treasury have declined nearly 19 percent for the first 7 months of fiscal year 2009 as compared to the same period in fiscal year 2008. A significant portion of this revenue loss is due to a decrease in tax receipts as a result of the current economic recession. To what extent do you expect tax revenues to increase as a result of federal efforts to create jobs and spur economic recovery?

FEDERAL RECEIPTS, FISCAL YEAR TO DATE (APRIL 2009)

	Year to date, fiscal year 2009	Comparable period in fiscal year 2008	Percent change
Total	\$1,256,066	\$1,549,720	– 18.9
Individual Income Tax	\$566,369	\$747,558	– 24.2
Corporation Income Taxes	\$70,781	\$171,142	– 58.6

Answer. The IRS does not predict the effect legislation will have on tax revenues. The Joint Committee on Taxation and the Department of the Treasury under certain circumstances will provide estimates of the revenue effects of proposed but unenacted tax legislation.

QUESTION SUBMITTED BY SENATOR BEN NELSON

Question. In a Ways and Means Subcommittee hearing on June 4, 2009, you said you would like to work with Congress to provide the Internal Revenue Service with more discretion regarding imposition of the 6707A penalty for failure to include reportable transaction information with a taxpayer's return. Can you elaborate on what kind of discretion would be appropriate, especially in cases where taxpayers acting in good faith unknowingly failed to file—or, worse, were misled into believing they did not need to file information about such transactions?

Answer. As we have stated before, the IRS is concerned there are taxpayers who have been caught in a penalty regime that was not intended by the legislation. Many taxpayers are subject to this penalty and the amount due significantly exceeds the tax benefit resulting from the transaction. Furthermore, the statutory language does not allow for any adjustment to the penalty based on the tax benefit to the taxpayer. We may be open to changes that allow sufficient flexibility for a 6707A penalty to be proportional to the tax benefit associated with the reportable transaction giving rise to the penalty. This change could improve the fairness of the penalty, provide some measure of relief for virtually all taxpayers, and simplify tax administration.

QUESTIONS SUBMITTED BY SENATOR SUSAN COLLINS

Question. The IRS is in the midst of a significant hiring initiative for enforcement staff as a result of its fiscal year 2009 budget. What enforcement areas will the new staff be focused on and what do you anticipate the resulting increased revenues to be?

Answer. The enforcement staff hired in fiscal year 2010 will be focused on the activities listed below and will generate over \$2 billion in additional revenue once they reach full potential in fiscal year 2012.

RETURN ON INVESTMENT ENFORCEMENT INITIATIVES

[Dollars in millions]

	Fiscal year 2010 enforcement investment			First year (fiscal year 2010)			Full performance (fiscal year 2012)		
	FTE ¹	Cost	Revenue	ROI	Cost	Revenue	ROI		
Direct Revenue Producing Initiatives									
Reduce the Tax Gap Attributable to International Activities. This initiative funds a multi-year investment to deal more effectively with increasing international tax activities of individual and business taxpayers. This effort addresses the underreporting of tax associated with international transactions as well as domestic taxpayers involved in offshore activities. It expands the IRS presence in the tax-exempt and governmental sectors and confronts international tax evasion schemes	2,330	\$332.1	\$611.1	1.8	\$262.8	\$2,049.7	7.8		
Improve Reporting Compliance of SB/SE Taxpayers. This initiative improves reporting compliance among Small Business/Self Employed (SB/SE) taxpayers by increasing examinations of business and high-income returns, exams involving flow-through entities, audits targeting employment, excise, and estate and gift taxes, and investigations of business non-filers	784	128.1	93.8	0.7	103.4	736.6	7.1		
Expand Document Matching for Business Taxpayers. This initiative increases coverage of the document matching program to reduce the number of taxpayers who misreport their income. Matching third party information such as W-2s and 1099s against tax returns is critical to ensure compliance	755	94.2	159.6	1.7	72.6	567.2	7.8		
Address Nonfiling/Underpayment and Collection Coverage. This initiative improves voluntary compliance and decreases nonfiling by broadening collection coverage with a focus on repeat non-filers and non-filers with high income. Additional collection staff will increase the number of collection actions against unpaid assessments and allow the IRS to close more collection cases	300	26.2	191.8	7.3	22.8	386.5	17.0		
	491	83.6	165.9	2.0	64.0	359.4	5.6		

¹ Total includes revenue and non-revenue generating FTE.

Question. Commissioner Shulman, how can we address the tax gap?

Answer. The Internal Revenue Service and Treasury issued an update of the 2007 Tax Gap Strategy report in early July. That report addressed this question in detail.

Question. Does IRS have an estimate of the tax gap attributable to international activities?

Answer. No. The data on which we base our tax gap estimates do not generally allow us to separate international and domestic issues. Moreover, some forms of noncompliance do not lend themselves to a clear characterization based on geography.

Question. If there is not an estimate of the effect of international activities on the tax gap, why is that the focus of the fiscal year 10 enforcement initiative?

Answer. Globalization has led to an increase in international tax activity, which has historically been an area of significant concern to the IRS. For example, foreign tax credits claimed by U.S. corporations increased by 71 percent between Tax Years 2000 and 2007, while foreign tax credits claimed by U.S. individuals increased by 133 percent during that time period. Likewise, between 2001 and 2006, foreign-source gross income of individuals grew 86.6 percent in real percentage terms, whereas worldwide income reported on all individual U.S. tax returns grew only 14.8 percent during that period.

Question. Please describe any plans the Service may have to develop an international tax gap estimate.

Answer. We are conducting a pilot study, beginning with Tax Year 2006, to extend our National Research Program (NRP) reporting compliance studies of individual returns to include a small sample of returns with international addresses. We hope to determine from this pilot how best to compile representative compliance data for this population. If successful, this approach may allow us to estimate this portion of the international tax gap. Future studies of corporation income tax reporting compliance will need to address this concern, as well.

Question. IRS reduced its performance goal for providing telephone assistance from 82 percent last year to 77 percent this year. Commissioner Shulman, why was the goal reduced and what does it mean for taxpayers? In your opinion, does this lower level allow for sufficient access for taxpayers to speak directly with an IRS assistor?

Answer. The IRS is dedicated to providing the best possible service regardless of the channel the customer chooses. Although the goal and actual CSR LOS was lower this year than in prior years, the IRS funded the Toll-free program in 2009 at higher levels than in prior years by allocating more staffing (full time equivalents (FTEs)) during filing season than in 2007 and 2008. The actual toll-free FTEs for 2007, 2008, and 2009 filing seasons were 3,067, 3,100 and 3,344, respectively. However, increased customer demand, the introduction of new programs such as the Identity Protection Specialized Unit, and increased complexity of the calls handled by assistors resulted in lower service levels, despite increased resources. From January 1st through April 18, 2009, the IRS serviced over 39 million taxpayers through both assistor and automated telephone service during the 2009 filing season. This level compares to just over 35 million taxpayers serviced during the same time period during the 2008 filing season and 32 million serviced in 2007. On most days, taxpayers were able to get to an assistor if they chose to wait. We provided an estimated wait time to the vast majority of callers, so they could make an informed decision about whether to wait or call back at a later time.

Question. This year, IRS's average actual telephone performance has been well below its goal. Next year, IRS can expect another year with high call demand given the Recovery Act tax law changes. What specific steps are you taking now to improve IRS's telephone performance for next year should call volume could remain high?

Answer. We are taking numerous steps to prepare for the coming year. During the 2009 filing season, there were 4.8 million calls from taxpayers asking for their prior year Adjusted Gross Income (AGI) or Personal Identification Number (PIN), which is required by online filers to submit their returns electronically. For 2010, we are developing both a web and automated telephone application to provide this information to taxpayers without requiring interaction with an assistor. This enhancement will free up assistors to handle more complex taxpayer questions. We will be implementing improvements in our Toll-free menus, which will get customers to the right resource faster. We will be expanding the use of estimated wait time announcements to more applications and customers. Lastly, we are planning to increase the number of staff on-rolls at times of peak customer demand during the filing season, through seasonal hiring.

Question. IRS has spent \$2.6 billion on its business systems modernization effort since 1999. Its Customer Account Data Engine (CADE), a part of BSM intended to

replace the Individual Master File, has cost over \$400 million since work on it began almost 5 years ago, but CADE has only delivered about 15 percent of the full capability intended. Please explain this small return on investment?

Answer. The IRS has received approximately \$309.3 million in funding for CADE over the past 5 years. With that funding, the IRS has delivered a complete tax return processing system for approximately 40 million taxpayers who are enjoying the benefits of substantially faster refunds. In addition, the CADE project has proved the IRS is capable of delivering a modern database with significant functionality, including improved financial accounting capabilities, which have allowed the IRS to make progress against addressing its material weakness in this area.

CADE also already includes capabilities to process Forms 1040, Schedules A, B, C, D, E, F, R, SE and Form 1040A, Schedules 1 and 3 for single and married filers and filers with certain dependents; extension Forms 4868; decedent and surviving spouse returns; certain math error notices; online address changes; returns with disaster area designations; receipt processing; and last name changes. In addition, CADE has supported legislative tax refund programs, such as Telephone Excise Tax Refunds and the recent Economic Stimulus payments.

The IRS created the statistic referenced in your question for different purposes during a very specific engineering analysis, and we never intended to reflect a holistic assessment of the status of the effort. It understates nearly half the percentage of taxpayers that are in the new system, and it also does not reflect that a substantial portion of the overall effort is expended in setting up infrastructure to process the very first tax return.

Finally, any discussion of return on investment should recognize the public's return on IRS IT investments. Because of the IRS's progress on CADE, approximately \$58 billion in refunds went out on average 5 days faster than they would under legacy systems. This improvement has real economic value to taxpayers, particularly those in difficult economic situations.

Question. Of the vast extent of IT security weaknesses that exist in IRS current and modernized systems, how much improvement in data protection can the IRS make with the requested \$90 million for IT Security and what data and systems are still vulnerable?

Answer. The way IRS business is transacted, the way the Service operates, and the way core tax administration is conducted have changed. These activities now rely on an interdependent network of information technology infrastructures. At the same time, threats from cyberspace have risen dramatically and are growing increasingly more complex, harder to detect and prevent. In order for the Service to keep abreast of the latest security threats from cyberspace and elsewhere, more strategic and tactical investments will have to be made to protect against the debilitating disruption of the operation of the IRS' information systems or breaches of the sensitive personally identifiable information entrusted to us by the American tax-paying public.

This initiative requests an increase of \$90.0 million and 36 FTE to improve IT security and address specific components of the Computer Security Material Weakness. At the more strategic level, this budget initiative will:

- Better ensure the integrity of the tax system and maintain taxpayer confidence;
- Allow the IRS to improve the privacy and security of taxpayer information;
- Segregate securely the development, testing, and production environments for IT systems, and;
- Implement the Federal Information Security Management Act (FISMA) security compliance controls on all enterprise-wide Windows and UNIX computing assets.

At the more tactical levels, specific activities that will be included in this initiative are:

- Implementation of Network Access Control to better manage what devices are permitted to connect to the internal network. This change will specifically strengthen controls over many of the 700+ remote places of duty.
- Bolsters the disaster recovery capabilities for the enterprise.
- Improve the replication of our production environment in our test and development environments. This improvement will enable more complete testing of security controls and their impact before moving new applications into production.
- Improving the real-time ability for the IRS to monitor and report on the security posture of all devices on the IRS network. This enhancement will allow the IRS to better understand how new and developing threats could potentially affect core business systems.
- Implementing data leakage protection tools to monitor and control the movement of sensitive information in and out of the IRS network.

- Providing an enterprise solution to deploy end-to-end audit log collection, storage, and reporting to directly address a major component of the Computer Security Material Weakness.

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

ENFORCEMENT

Question. In the 1998 IRS Restructuring Act, Congress directed the IRS to refocus its mission not only to enforcement of the tax laws, but also serve the public and meet the needs of taxpayers. With the emphasis that you and the Administration has placed on enforcement, it appears that the pendulum is swinging further back to the “bad old days” of heavy handed IRS enforcement that led to the restructuring legislation in the first place.

Are the enforcement initiatives that the IRS has announced this year coming at the cost of taxpayer service? What steps are you taking to ensure that taxpayer service remains an equal part of the IRS’ mission?

Answer. The IRS remains committed to a balanced program of assisting taxpayers in both understanding the tax law and paying the proper amount of tax.

The fiscal year 2010 President budget request of \$2.27 billion for taxpayer service will allow the IRS to continue improvements for both the quality and efficiency of taxpayer service, using a variety of steps including, person-to-person, telephone, and web-based and self-serve methods to help taxpayers understand their tax obligations and pay what they owe.

The IRS provides year-round assistance to millions of taxpayers including: Outreach and education programs; issuance of tax form and publications; rulings and regulations; toll-free call centers; IRS.gov web site; Taxpayer Assistance Centers (TACs); Volunteer Income tax Assistance (VITA) sites; and Tax Counseling for the Elderly (TCE).

The IRS will continue to implement and administer these critical programs within the levels contained in the budget request.

BUSINESS SYSTEMS MODERNIZATION

Question. For many years, the IRS has struggled to update its computer systems to improve processing, enhance collections, and strengthen customer service. To address IRS’ computer system problems, the Business Systems Modernization (BSM) was created. The center-piece of BSM is the Customer Account Data Engine (CADE) project.

What is the status of BSM?

Answer. The BSM program is a critically important component of the IRS’s overall technology portfolio. In recent years, the IRS has consistently delivered on its commitments and is providing systems that deliver concrete benefits to taxpayers. Some of these benefits include:

- CADE.*—Issuing refunds for nearly 40 million taxpayers on average 5 days faster than existing legacy systems;
- Modernized e-File.*—Dramatically reduced processing error rates, which eliminates rework for taxpayers and the IRS;
- E-Services.*—Delivering value-added, web-based services for taxpayers and the tax practitioners who serve them;
- Account Management Services.*—Providing IRS customer service representatives (CSRs) with faster and improved access to taxpayer account data with real-time data entry, validation and update of taxpayer addresses; and
- Filing and Payment Compliance.*—Placed more than 203,800 taxpayers with Private Collection Agencies since September 2006, facilitating the collection of more than \$90 million on cases formerly unassigned for active collection.

The Modernized e-File project is on track to begin delivery of Form 1040 and certain schedules in 2010, which will extend the benefits of this program to individual taxpayers.

The CADE project has delivered a modern database with significantly more functionality than the Individual Master File, including improved financial accounting capabilities, which have allowed the IRS to make progress against addressing its material weakness in this area. In 2008, the IRS refined the program focus to target an accelerated integration of the legacy and modernized databases to get all 140 million taxpayers into a common relational database, and into a faster processing cycle. That database will serve as a strategic foundation for the IRS’s next generation taxpayer service and compliance programs.

Finally, as the IRS proceeds with its modernization efforts, we are mindful of maintaining a holistic, overall portfolio approach to our technology programs. In particular, we are focused on balancing our work on modernization with appropriate investments in core IT operations, and in particular, IT security.

Question. When will the CADE system be able to handle all individual and business tax returns?

Answer. The Commissioner has set a goal of completing the development of the taxpayer account database for all individuals, and moving to a faster processing cycle within 5 years. The team has developed and delivered a long-range plan, and is in the process of developing the BSM expenditure plan for fiscal year 2010, each of which provide further details on the interim deliverables for 2010 and 2011.

In the interests of prioritization and focus, the IRS plans to deliver on the individual account database before upgrading the business tax account database.

PRIVATE DEBT COLLECTION

Question. With the start of the new Administration, the IRS abandoned its private debt collection program.

What is your justification from a purely business case perspective for abandoning this program for collecting small-dollar, non-complex collection cases? Are we to assume that these tax debts will now just go uncollected, since IRS officials have previously testified that the agency does not have the staff to work these cases? Or, do you plan to pull staff off of more complex, higher-dollar cases to work the ones that were handled by the private debt collection program?

Answer. In early 2009, the IRS completed a cost effectiveness study of the Private Debt Collection (PDC) program, supported by an independent review, which showed that it is reasonable to conclude that when working similar inventory, collection efforts are more cost-effective using IRS employees rather than outside contractors. In addition, from 2002 to 2008, the percentage of potentially collectible inventory in active IRS collection status increased from 62.2 percent to 71.4 percent, and the dollar amount of potentially collectible inventory shelved due to lack of IRS resources declined from \$7.6 billion to \$3.6 billion. These elements contributed to the March 2009 decision not to renew contracts with the private collection agencies (PCAs).

The IRS plans to work the types of cases that were assigned to PCAs as part of its overall collection strategy, which includes notice, telephone, and in-person contact. A part of this strategy is supported by a fiscal year 2010 IRS budget initiative which requests funding for two new Automated Collection System sites.

TAX GAP

Question. The Administration's budget includes a number of proposals aimed at closing the so-called "tax gap," many of which originated in the last couple of budgets submitted by the previous Administration. Yet, the last estimate that the IRS undertook to quantify the tax gap was in 2001.

When is the IRS going to update its tax gap estimates so we can measure accurately the success of these initiatives?

Answer. We do not have plans to update estimates of all components of the tax gap simultaneously for a common year since new data will not be available for all components at the same time. Furthermore, any post-initiative tax gap estimates will require compliance data to be compiled and analyzed for a tax year in which the initiatives are fully implemented. Since the tax gap estimates are, of necessity, very approximate, it would probably be more effective to estimate the effect of the initiatives by analyzing trends of observable tax data, such as tax revenue or enforcement revenue, accounting for other factors that have caused the trends to vary over time.

Question. Does the IRS plan to estimate the extent to which the current tax gap is associated with taxpayers' intentional efforts to evade the tax law as opposed to honest mistakes due to the incredible complexity of our tax code today?

Answer. The IRS seeks to be able to distinguish intentional noncompliance from unintentional mistakes. Several of our reporting compliance studies have tried to address this question. However, we have found that it is virtually impossible for auditors to know for sure what motivated an error. It is relatively easy for a taxpayer to claim that an error was an unintentional mistake (e.g., "I lost my receipts," or "I forgot about that income."), whether that is true or merely an attempt to avoid penalties and more detailed scrutiny. Moreover, even if IRS employees could distinguish between intentional and unintentional errors, the unintentional errors among all returns would likely include both overstatements and understatements of tax in roughly equal amounts. Since the tax gap is defined as the aggregate amount of un-

derstatements net of overstatements, those unintentional overstatements and understatements are likely to cancel each other when added to the tax gap. If so, the tax gap likely includes very little net unintentional noncompliance. Having said that, though, the IRS seeks to minimize unintentional noncompliance since it represents unnecessary burden on both taxpayers and the IRS. It is also important to point out that, in addition to spawning unintentional errors, the complexity of the tax code undoubtedly creates opportunities for willful noncompliance.

Question. Does the IRS plan to produce an estimate of how much of the tax gap is associated with international transactions, since the Administration has placed so much emphasis on this compliance area?

Answer. We are conducting a pilot study, beginning with Tax Year 2006, to extend our NRP reporting compliance studies of individual returns to include a small sample of returns with international addresses. We hope to determine from this pilot how best to compile representative compliance data for this population. If successful, this approach may allow us to estimate this portion of the international tax gap. Future studies of corporation income tax reporting compliance will need to address this concern, as well.

IMPLEMENTATION OF TAX GAP STRATEGY

Question. In 2006, the Treasury Department and the IRS prepared a strategy for addressing the tax gap, and in 2007, the IRS released a progress report on the implementation of that strategy.

Please provide me an update on the implementation of the tax gap strategy, including new initiatives that the IRS plans to implement over the next 5 years to close the tax gap.

Answer. The Internal Revenue Service and Treasury issued an update of the 2007 Tax Gap Strategy report in early July. That report addressed this question in detail.

SUBCOMMITTEE RECESS

Senator DURBIN. We thank you for your appearance today and thank Senator Collins.

This subcommittee stands recessed.

[Whereupon, at 12:33 p.m., Tuesday, June 9, the subcommittee was recessed, to reconvene subject to the call of the Chair.]